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Recharacterizations and the Nature of Theory In Corporate Tax Law

Saul Levmore

ARTICLES

RECHARACTERIZATIONS AND THE NATURE OF THEORY IN CORPORATE TAX LAW

SAUL LEVMORE†

INTRODUCTION

A source of continuing controversy and mystery in corporate tax law is the acceptability of certain recharacterizations[1] of taxpayer transactions and the unsuitability of others in the eyes of both the courts and the Internal Revenue Service ("IRS" or "Service").[2] Although it is generally understood that taxpayers may be held to the form in which they cast a transaction if this form is agreeable to the Commissioner of Internal Revenue,[3] little is known about those types of forms that taxpayers may employ successfully to escape various taxes or the extent of the Commissioner's power to recharacterize various taxpayer maneuvers.[4] No systematic framework for analyzing recharacter-

† Professor of Law, University of Virginia. I have benefited greatly from conversations with Boris Bittker, Richard Fallon, Henry Hansmann, Hideki Kanda, Julie Roin, Roberta Romano, and Paul Stephan, and from a workshop at the Boston University School of Law.

[1] A recharacterization is simply the renaming or recasting of a taxpayer's transaction by the Internal Revenue Service or the courts to match its perceived substance or true character. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 14.51 (5th ed. 1987) (discussing how the judicial doctrines of "business purpose," "continuity of business enterprise," and "step-transactions" are used to recharacterize or recast corporate reorganizations); *see, e.g.,* Gregory v. Helvering, 293 U.S. 465, 469-70 (1935) (discussing a failed attempt to recharacterize a tax-free reorganization as a taxable sale of a business).

[2] *See, e.g.,* Clark v. Commissioner, 828 F.2d 221, 222 (4th Cir. 1987) (puzzling over whether to characterize a distribution as occurring before or after a corporate reorganization).

[3] *See* B. BITTKER & J. EUSTICE, *supra* note 1, ¶ 14.51 (noting that, in practice, the step-transaction principle is most often applied at the request of the government rather than over its opposition); Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance,* 77 YALE L.J. 440, 472-74 (1968) (analyzing Hand's decisions concerning the acceptance of a taxpayer's choice of form for assessing tax obligations).

[4] *See generally* Chirelstein, *supra* note 3; Kingson, *The Deep Structure of Taxation: Dividend Distributions,* 85 YALE L.J. 861, 912-13 (1976) (proposing that the

izations has emerged that explains this phenomenon in corporate tax law.

This Article focuses on transactions governed by subchapter C of the Internal Revenue Code (the "Code"), surely the heartland of recharacterization questions. It argues that four rules have justifiably influenced the acceptability of recharacterizations. These rules are that recharacterizations be "complete," "consistent," "brief," and "direct." Part I of this Article introduces the four rules that comprise this theory. Part II utilizes the rules in the context of specific recharacterization questions that arise in corporate tax law. Finally, Part III explores the normative aspects of this analytical framework. While much of the law governing these transactions has substantial normative ambiguity, this Article will argue that these four descriptive rules have an implicit normative component that supports their appeal as a guide to recharacterization questions.

I. The Hidden Rules of Corporate Tax Law

The four recharacterization rules set forth in this Article have distinct meanings. A "complete" recharacterization is one with components that explain all available data without contradicting reality. For example, assume that *A* and *B* are each 50% shareholders of a corporation that pays money to *A* alone. Completeness might be satisfied by a claim that this payment to *A* was a salary, especially if *A* planned to work for the corporation. Completeness would not be satisfied, however, by a claim that there was a redemption of *A*'s shares alone. So long as *A* and *B* continue to enjoy equal voting power, there will be evidence contradicting the claim that only *A*'s shares were redeemed. Similarly, a claim that the corporation distributed a pro rata dividend to both *A* and *B*, thereby increasing the assets or wealth of each shareholder, would also be incomplete. Financial data concerning the relative assets of the parties will contradict this dividend recharacterization because, in reality, only *A*'s assets increased during the actual transaction. Such unexplained facts, or loose ends, do not exist in complete recharacterizations.

A "consistent" recharacterization does not contradict another

consistent treatment of tax concepts in deciding different tax issues will result in greater statutory simplicity and predictability). For background to the approach taken in this Article, see generally Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform,* 87 YALE L.J. 90 (1977) (tracing the development and synthesis of corporate tax law and its utility for tax reform efforts by examining alternatives not taken in the law). Discussion of the substantive topics discussed herein can also be found in B. BITTKER & J. EUSTICE, *supra* note 1.

recharacterization or ordering[5] that is deemed acceptable by the tax system. For example, if *A* is taxed as having received compensation from the corporation, then it would be inconsistent to deny the corporation a deduction for that payment if it is reasonable.[6] This simple illustration of consistency avoids the question of when circumstances are sufficiently related to require consistent treatment, much as the aphorism "like cases should be treated alike" only begins the process of identifying relevant similarities and distinctions. The boundaries of consistency are confronted in more detail in Part III of this Article; for now, it is sufficient to note that consistency may require that recharacterizations of two "related" transactions manifest a symmetry or coherence in the application of the tax law.[7]

A "direct" recharacterization is one that does not overshoot and then return to its mark. An itinerary that takes a traveler from New York to Chicago by way of Seattle is quintessentially indirect. Similarly, it would be indirect to describe *A,* who was oversalaried in the earlier example, as first having received an amount larger than she now really enjoys and then returning the difference to the corporation as a gift. Such a sequence would avoid incompleteness, for it would place the same assets at the parties' disposal as they ultimately enjoyed in reality. Completeness is achieved, however, only by overshooting and then backtracking to the real amount enjoyed by *A*.

Finally, a "brief" recharacterization takes no more steps to achieve completeness than does another available recharacterization.[8] Similar to the other rules, this last rule of recharacterization is derived from the methods of scientific inquiry which often favor elegance in the form of fewer explanatory variables.[9] For example, the indirect recharacteriza-

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[5] Competing recharacterizations often differ only in the order in which they place components of a transaction. *See, e.g., infra* notes 74-77, 96-97 and accompanying text.

[6] *See* I.R.C. § 162(a)(1) (1982) (allowing deductions for salary expenses, but not dividends paid). Consistency of the sort just sketched is likely to be a murky and, perhaps, impossible norm. At a minimum, its very mention leads to questions of how to define the boundaries of the system in which there will be consistency and how to decide when things are close enough in subject so as to expect consistent treatments. These matters are confronted lightly in Part III.

In order to conform to A UNIFORM SYSTEM OF CITATION, § 12.8.1 (14th ed. 1986), the citations to the Internal Revenue Code provided in this Article refer to 26 U.S.C. (1982), 26 U.S.C. (Supp. III 1985) and/or 26 U.S.C.A. (West Supp. 1987), depending on the date relevant amendments were codified in the United States Code, rather than to the 1986 Internal Revenue Code. All section references in this Article, however, are identical to those appropriate under the 1986 Code.

[7] *See infra* text accompanying notes 112-16, 129-34.

[8] These definitions allow an indirect characterization to be as brief as a direct one because it may not be possible to take the shortest route between two points without being incomplete.

[9] This notion of economy has ancient origins. *See* G. LEFF, WILLIAM OF OCKHAM

tion sketched earlier appears inelegant compared to the simple, briefer tale of a salary payment to *A*.

Although the definition of these four recharacterization rules may appear to have substantial normative content, Part II of this Article begins with a strongly positive bias. The discussion explores the descriptive utility of the rules just defined in distinguishing between those recharacterizations and arguments that seem to succeed in corporate tax law and those that do not. The four distinctions, tools, or "hidden rules" are developed through a discussion of various transactions that haunt the student and practitioner of subchapter C.[10]

II. Recharacterizations and the Hidden Rules of Corporate Tax Law

A. *Recharacterizing Excessive Salaries*

The notion of completeness in the recharacterization of events in the law is hardly novel. Much as an accusation of murder is more compelling if the prosecutor is able to explain how a weapon bearing the defendant's fingerprints caused a death, so too the Commissioner's claim for tax revenues or taxpayers' arguments against the imposition of certain taxes may be more compelling when they attach to stories that fully explain observable events. The search for perfect completeness in tax matters is often futile, however, because by extracting money, the tax process itself interferes with the chain of observable events. Nevertheless, a consideration of the completeness of recharacterizations with respect to pretax financial data is useful.

This suggestion can be examined in more detail in the following hypothetical which expands upon the example introduced earlier.[11] Assume that *A* and *B* are the two 50% shareholders of Corporation *X*. Apart from their involvement with *X*, they are unrelated shareholders. *A* is the managing officer of *X* while *B* is a passive investor. *X*'s profits amount to $1,400,000 before tax and before the payment of a salary to *A*. *X* pays *A* a salary of $400,000, reports a net profit of $1,000,000, and pays a corporate tax of $340,000 under section 11 of the Internal

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35 & n.141 (1975) (attributing to Aristotle the principle, "it is vain to do by more what can equally be done by fewer").

[10] This Article does not explore the utility of these rules with respect to all areas of corporate tax law in which recharacterizations figure prominently. For example, there is no discussion of the "spinning-off" of unwanted assets by a corporation. The rules developed here, however, will be useful in many areas of tax law.

[11] For a sampling of cases which correspond to this first hypothetical, see S. Surrey, W. Warren, P. McDaniel & H. Ault, 2 Federal Income Taxation 305-310 (2d ed. 1980) [hereinafter S. Surrey].

Revenue Code.[12] The remaining $660,000 is then paid out in dividends to *A* and *B*. Assume that the Internal Revenue Service later correctly determines that one half of the $400,000 salary to *A* was excessive and improperly deducted by *X*. Assume further that *X* has a sufficiently large earnings and profits account for dividend distributions to receive ordinary income treatment.[13] Before the excess salary determination, the Service collected tax on the $400,000 salary and on the $330,000 dividend distribution from *A*, and it collected tax on the $330,000 dividend from *B*. Given the individual tax rate of 28% applicable to *A* and *B*,[14] the Commissioner has collected $204,400 from *A* (28% of the sum of $400,000 and $330,000) and $92,400 from *B* (28% of $330,000). Including the $340,000 collected from *X*, the government has thus collected a total of $636,800. The following question now arises: what sort of tax treatment should apply to the excessive salary? Assuming that no fraud claim is contemplated by the Internal Revenue Service, six possible recharacterizations, or tax treatments, are particularly noteworthy.

> (a) Characterize the excess salary as a gift from *X* to *A*, and accept both the dividends as paid to *A* and *B* and the remainder of *A*'s salary as they were originally cast.

This recharacterization will produce a number of tax consequences. First, and trivially, it will allow *X* to deduct $25 of this gift under section 274(b).[15] More importantly, *B*, as an implicitly agreeable shareholder, is treated for gift tax purposes as having transferred half of the excess salary or gift of $100,000 to *A*. *X* is then denied the $200,000 excess deduction.[16] Finally, *A* is entitled to a refund because she paid a tax on $730,000 but is now regarded as receiving $530,000 of taxable income.

This recharacterization is complete. *A* and *B* are equal shareholders at the close of the recharacterization and *B*'s bank account has in-

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[12] *See* I.R.C. § 11 (1982 & Supp. III 1985 & West Supp. 1987) (imposing a 34% corporate tax rate).

[13] *See* I.R.C. §§ 301(c)(1), 316(a) (1982).

[14] *See* I.R.C. § 1 (1982 & Supp. III 1985 & West Supp. 1987).

[15] *See* I.R.C. § 274(b) (1982 & Supp. III 1985 & West Supp. 1987) (limiting deduction for gift claimed as business expense under I.R.C. § 162 to $25). It is conceivable that the Commissioner would seek to disallow even such a limited deduction as neither ordinary nor necessary. *See* I.R.C. § 162(a) (1982) (allowing deductions for ordinary and necessary business expenses).

[16] *See* Treas. Reg. § 25.2511-1(h)(1) (1987) (stating that a gift from a corporation to one of its shareholders "is a gift to [the shareholder] from the other stockholders, but only to the extent it exceeds [the implicit donor's] own interest in such amount as a shareholder"). The rule seems incomplete in failing to describe the character of the portion received that is not a gift, but because (a) is of little interest to the Commissioner, it is unnecessary to pursue further the gift tax rules.

creased by $330,000 as a result of the dividend paid by *X*. *A*'s $730,000 is similarly accounted for, from a combination of salary, gift, and dividend sources, and *X* has paid out $1,060,000 apart from its tax liabilities. None of these events is contradicted or left unexplained by a real-world occurrence. Recharacterization (a) will require *X* to pay more to the government than *X* actually paid before the Commissioner of Internal Revenue intervened. Similarly, the refund that is owed *A* might at first seem to indicate that (a) contradicts reality. It would be unrealistic, however, to weigh such contradictions heavily and to expect "perfect" completeness even with respect to after-tax events. For example, the government can surely claim payments from a taxpayer who has spent all her income and paid no taxes, a move which presupposes a right to undo the reality that the taxpayer has created. In short, there is little utility in assessing the after-tax completeness of a recharacterization and (a), therefore, can be labeled "complete" because, excluding tax liabilities, nothing in (a) contradicts the events that occurred in reality. This Article does not suggest that (a) ought to be the method of the law simply because it is complete. First, there are likely to be many competing complete recharacterizations of any transaction. More importantly, it would be a mistake to leap from an aesthetic reaction triggered by one illustration to a normative conclusion. It is more useful for the moment to focus on the positive power of rules like completeness to distinguish between recharacterizations that are acceptable and unacceptable to the courts or the Internal Revenue Service.[17]

When the corporate tax rate is higher than the individual rate, the tax consequences associated with (a) are somewhat attractive to the Commissioner. The government will collect an additional $68,000 from *X* (34% of $200,000) and a few thousand dollars by way of a gift tax on *B*. On the other hand, *A* is entitled to a $56,000 refund (28% of $200,000) because *A* mistakenly reported her gift as taxable income. If *A*'s marginal tax rate is higher than *X*'s,[18] then (a) is unattractive to the

[17] The discussion in Part III argues that there *is* normative content to positive rules like completeness, but the immediate task is to assess the positive strength of various suggested rules. The tools developed in this Article may not be particularly useful in describing the explicit rules found in the Code itself. Congress can, for example, simply decree that something like pension benefits given by an employer to an employee is deductible to the former and yet not income to the latter. Completeness would not, therefore, be a useful concept in predicting legislative behavior. *See infra* note 70. Although this Article addresses only tangentially the question of why judges or other decisionmakers might behave as if they aimed for completeness, consistency, brevity, and directness, it seems evident that any plausible theory of legislation must be quite different from any convincing theory of judicial decisionmaking.

[18] In the current two-tier tax system, corporate rates are higher than individual (shareholder) rates. *Compare* I.R.C. § 1 (1982 & Supp. III 1985 & West Supp. 1987) (28% rate on individuals) *with* I.R.C. § 11 (1982 & Supp. III 1985 & West Supp.

Commissioner who may owe more to *A* than is now collected from *X* and *B*. Because the Commissioner is not required to accept the first complete characterization that can be attached to a transaction crafted by taxpayers, it is useful to consider other revenue-raising alternatives.

> (b) Disallow $200,000 of *X*'s deductions and collect an additional $68,000 in corporate tax. The $660,000 in dividends paid out by *X* is accepted as cast, in addition to the first $200,000 paid to *A* as salary. The character of the second $200,000 received by *A* is ignored.

Alternative (b) is the easiest revenue-raising path available to the Commissioner. It adds $26,000 to the total tax bill, although it fails to explain the source of all of *A*'s money. This incompleteness cannot be sidestepped by a claim that *A* has simply been mistakenly overpaid because the law will not permit taxpayers to reverse these steps. If *A* returned the excess, the Commissioner would not forgive *A*'s tax on all that she originally received.[19] Moreover, the law of restitution will not normally allow *X* to force *A* to return the overpayment.[20]

The characterization in (b), moreover, yields consequences which are incongruous with those encountered by similarly situated taxpayers who correctly report their dealings. Had *X* originally paid a reasonable salary of $200,000, then paid $408,000 (34% of $1,200,000) in corporate tax, and then distributed the remaining $792,000 as a dividend to *A* and *B*, the government's total catch would have been $685,760 ($408,000 plus 28% of the sum of $200,000 and $792,000). The Commissioner in (b), however, asks not simply for this amount, as opposed to the $636,800 actually paid, but rather for $704,800. In the absence of a statutory penalty, an attempt to collect more than the Code actu-

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1987) (34% rate on corporations). This rate structure must be short-lived, however, for it discourages conducting business in the corporate form. As enterprises that have flexibility in their form of operation depart from corporate status, Congress can be expected to recapture them through a reduction of the two-tier bite.

[19] *See* Blanton v. Commissioner, 379 F.2d 558, 558 (5th Cir. 1967) (per curiam), *aff'g* 46 T.C. 527, 530 (1966). A different outcome would result if, before receiving compensation, *A* had bound herself contractually to return her salary to the extent that it might be held nondeductible by *X*. *See* Rev. Rul. 69-115, 1969-1 C.B. 50, 51; *see also* B. BITTKER & J. EUSTICE, *supra* note 1, ¶ 7.05 (citing decisions involving agreements to refund nondeductible compensation).

[20] Oddly enough, there appears to be no case on point. The statement in the text is somewhat influenced by the sense that the payment by *X* was a calculated risk and not really a mistake at all. The traditional approach is to think of *X*'s mistake as one of law and not of fact, for it concerned the deductibility of the entire salary under the Code. Such mistakes are generally said to result in the denial of restitution. *See* 3 G. PALMER, THE LAW OF RESTITUTION §§ 14.27, 16.4 (1978) (surveying the general rule that relief will not be given for mistake of law).

ally requires from taxpayers is unsettling. It is unconvincing, moreover, to argue that a penalty is fitting because it cleverly discourages taxpayers from claiming excessive deductions and from playing the audit lottery. For example, suppose that *B* were in a higher tax bracket than *A* and the Commissioner sought to recharacterize this transaction as involving the following: a $200,000 salary, a $408,000 corporate tax, and then a lopsided $792,000 payment by *X* to *B* followed, for the sake of nominal completeness, by a gift from *B* to *A*. The defects in this last recharacterization do not appear to be overcome by the cleverness of a large penalty. On the contrary, in the absence of legislative authorization, the imposition of penalties is too arbitrary a guide for recharacterizations because the possible penalties are virtually unlimited.

Some of the criticisms of (b) may be avoided simply by regarding all of the $400,000 paid to *A* as salary as originally cast but by insisting that only $200,000 is deductible under section 162(a) of the Code, which grants a deduction for "a reasonable allowance for salaries."[21] Such an approach is consistent with the view that this particular language represents a form of sumptuary legislation intended to discourage excessive expenditures by employers and, through a trickle-down effect, by employees. Approach (b), then, has two requirements: first, a belief that, even absent legislative declaration,[22] there is such a thing as a taxable salary that is simply not deductible to the payor, and second, either a constrained conception of completeness, or a taste for focusing on ends rather than means. The Commissioner's own apparent preference for recharacterization (c), below, rather than for (b) may indicate that even the Commissioner regards (b) as too incomplete a recharacterization.[23]

(c) Regard *X* as paying *A* a nonexcessive $200,000 salary

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[21] I.R.C. § 162(a)(1) (1982).

[22] The provision was originally enacted not to limit deductibility, but to authorize deductions greater than amounts actually paid out, *see* Griswold, *New Light on "A Reasonable Allowance for Salaries"*, 59 HARV. L. REV. 286, 287 (1945); therefore, there is little to gain by focusing on the statutory language. Note, by way of comparison, that in other tax systems, statutes do explicitly categorize excessive salary payments so that they are nondeductible to the payor but taxable to the recipient. *See, e.g.*, BNA TAX MANAGEMENT PORTFOLIO, BUSINESS OPERATIONS IN JAPAN A-32 (1984) (describing article 35(1) of the Japanese Corporate Tax Law).

[23] The Code can be read as leaving room between that which is reasonable under § 162(a) and that which is a dividend under § 301, but courts have not declined to find non-pro rata constructive dividends. *See, e.g.*, Nor-Cal Adjusters v. Commissioner, 503 F.2d 359, 360 (9th Cir. 1974) (affirming the Commissioner's decision that bonuses paid to officer-stockholders were not deductible business expenses); W.T. Grant Co. v. Commissioner, 58 T.C. 290, 309-10 (1972) (concluding that net dividend credits under an employee stock purchase plan constituted deductible compensation). The same is true of cases involving benefits in a form other than salary. *See, e.g.*, 58th Street Plaza

and as distributing a $330,000 dividend to *A* and to *B*. View the excess salary paid to *A* as an extra $200,000 dividend from *X* to *A*.[24]

The Commissioner collects an extra $68,000 from *X* because there is no deduction for dividends paid, and the money received by *A* and *B* is all salary and dividends. The total tax bill is $704,800 (34% of $1,200,000 profits from *X*, and 28% of the sum of $200,000 in *A*'s salary, $660,000 in dividends, and $200,000 in the extra dividend), as in (b).

In the absence of explicit statutory instructions to treat excessive salaries in this manner, this recharacterization is perhaps the most shocking. An important piece of this approach is, after all, illegal under state law because it involves a non-pro rata dividend payment. In the framework developed thus far, (c) might be branded as incomplete because no explanation is given as to why *B* would consent to the transaction described. In the absence of such an explanation, it might be presumed that *B* acted generously; however, this type of behavior is known as a gift and generates less tax revenue.[25] The remaining approaches to

Theatre, Inc. v. Commissioner, 195 F.2d 724, 725 (2d Cir. 1952) (recharacterizing a low rental price of property to one shareholder as a constructive dividend even though this implied non-pro rata treatment). These courts do not, however, address the non-pro rata problem.

This discussion does not intend to suggest that the Commissioner or the courts will never select the recharacterizations outlined in (a) or (b). In Peacock v. Commissioner, 256 F.2d 160, 162 (5th Cir. 1958), for example, approach (a) was chosen. *See generally* cases collected in S. SURREY, *supra* note 11, at 305-10; *see also* Richards v. Commissioner, 111 F.2d 376, 376-77 (5th Cir. 1940) (following (a) by characterizing sole shareholder's use of corporation-owned homes as a gift).

For decisions that follow (b) and deny salary deductions but do not follow through with any characterization of the benefit received by the distributee, *see, e.g.,* Mosby v. Commissioner, 47 T.C.M. (CCH) 1154, 1155-56 (1984) (disallowing the recharacterization of compensation as a dividend by the taxpayer whose corporation had no earnings and profits); Woesner Abstract & Title Co. v. Commissioner, 47 T.C.M. (CCH) 722, 724-25 (1983) (denying a closely held corporation a deduction for excessive compensation to the chairman of the board).

[24] A number of cases have taken this approach. *See, e.g.,* H.H. Mink & Son Bag Co. v. Commissioner, 29 T.C.M. (CCH) 778, 785 (1970) (characterizing a non-pro rata distribution for reimbursement of disallowed travel and entertainment expenses as a constructive dividend); Ernest V. Berry Inc. v. Commissioner, 23 T.C.M. (CCH) 1077, 1084 (1964) (recharacterizing excessive salary as a dividend); *see also* American Foundry v. Commissioner, 536 F.2d 289, 292 (6th Cir. 1976) (Commissioner arguing for a non-pro rata dividend recharacterization, but court finding compensation not excessive); Garrison v. Commissioner, 52 T.C. 281, 286-87 (1966) (recharacterizing non-pro rata bonus as a distribution in liquidation). Again, the non-pro rata character of these "distributions," noted presently in the text, *see infra* note 25 and accompanying text, is not addressed in these decisions.

[25] Outside of the framework developed in the Article, (c) is unattractive simply for incorporating an illicit step. The expression "unattractive" is used rather than "wrong" because, as a matter of law, nothing prevents federal statutes or commissioners from

this excess salary problem are designed around this flaw in recharacterization (c).

> (d) Insist on a pro rata approach. Allow only $200,000 of the salary from *X* to *A* and collect $408,000 in corporate tax. Characterize the remaining $792,000 as distributed pro rata, $396,000 to each shareholder. Finally, complete the recharacterization with a gift of $66,000 from *B* to *A* in order to leave *B* with what she actually received, $330,000.

This approach employs what might be called an "equal treatment" recharacterization rule. The equal treatment notion can be understood at two levels. First, it suggests that when a dividend distribution is part of a recharacterization, that distribution must conform to the norms of corporate law and treat all shareholders equally. A more powerful version of the equal treatment principle would insist that *whenever* money or property that is not clearly in return for services or goods received flows out of a corporation, it should be characterized as distributed pro rata to all shareholders. This second version will be called the equal treatment rule of recharacterization, for the first version is little more than an objection, albeit a powerful one, to one recharacterization of one type of transaction, specifically the approach illustrated in (c). Moreover, a recharacterization that incorporates a non-pro rata dividend distribution can simply be regarded as illicit or as incomplete for failing to explain why other shareholders do not object to the non-pro rata payout.

Although the more powerful version of the equal treatment rule might be applied to a variety of transactions, it will not prove to be a useful, positive rule in understanding tax law. In some contexts, the second, more powerful version of the equal treatment rule is little more than an application of the completeness notion because non-pro rata sales or redemptions of stock, unlike dividends, are not by themselves implausible at all. For example, an approach to *A*'s excessive salary that described a sale by *A* of shares of *X* stock back to *X* as the means by which *A* received her second $200,000 is not by itself implausible or illicit because, by returning shares, *A* gives appropriate consideration for her money. It is, however, incomplete because it is at odds with an important observable event, namely, *A*'s continuation as a 50% share-

instituting rules about the deductibility of payments that happen to be identical to those that would apply to a series of transactions that contained one step that was illegal under state law. On the other hand, taxpayers might well avoid the treatment suggested in (c) by stressing its "unattractive" feature. Regardless, it is useful at this stage to note other approaches to the excess salary problem; the remaining recharacterizations are designed to avoid the distribution of a non-pro rata dividend.

holder of the firm. The fact that this recharacterization is not attempted by litigants may reflect its unacceptably light tax consequences[26] or, perhaps, the predictive utility of the completeness rule. One might try to bolster this sale-of-stock recharacterization, in which *A*'s excessive salary is regarded as the proceeds of a redemption of some of *A*'s stock by *X*, by demanding that *A* actually surrender the appropriate number of shares of *X* stock and become a less substantial shareholder. While this modification would make the recharacterization complete because *A* would become a smaller shareholder than *B*, it attributes to the government too powerful a tool, namely, the ability to require reshuffling of stock ownership. The common law of tax and the Code itself, after all, normally limit their reach to the relationship between a taxpayer and the government. A tool that seeks to change the relationship between one citizen and another by altering stock ownership seems inordinate.

The equal treatment recharacterization in (d) is incomplete because it is contradicted by observable events.[27] Viewed from a pre-tax perspective, which as discussed earlier, is the correct vantage point from which to judge these recharacterizations,[28] (d) leaves *B* with $330,000, or just what *B* enjoys in actuality. On the other hand, *A* actually receives $400,000 in "salary" plus a $330,000 dividend. Recharacterization (d), however, describes *A* as receiving not $730,000, but $662,000 ($200,000 in salary plus a $396,000 dividend plus a $66,000 gift). The discrepancy of $68,000 is no mystery; (d) describes *X* as paying a tax that is $68,000 larger than that actually paid. Therefore, unless *X* is pushed into debt, it is impossible to leave both *A* and *B* in the positions in which they are actually observed. In short, the financial conditions of the shareholders in this recharacterization depend on *X*'s tax payments.[29]

One way to avoid this contradiction or incompleteness is to picture

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[26] Even if *A*'s stock basis is very low, the refund that will be owed to *A* will offset the extra revenue collected from *X*.

[27] One might wonder at this point whether *any* recharacterization is complete. It might seem, for example, that no recharacterization involving a redemption of shares could be complete because the number of shares outstanding in reality will then contradict those remaining in the recharacterization. It is appropriate to distinguish away such trivial kinds of incompleteness. Stock splits and reverse splits are so easy to manage that a contradiction about the number of shares outstanding is much less significant than, for example, a contradiction about the relative holdings of these shares. This Article will examine numerous recharacterizations that are quite complete and will occasionally indicate where stock splits could be added to polish otherwise complete recharacterizations.

[28] *See supra* text following note 16.

[29] Although this vantage point has been discouraged, note that a post-tax perspective will also not yield a complete recharacterization.

X as worrying about its taxes only later in time. Consider the following:

> (e) *X* paid $200,000 to *A* as salary. Although it had assets of only $792,000 remaining after-tax, *X* then distributed $860,000 in dividends. *B* gave $100,000 out of her $430,000 dividend to *A* as a gift.

This recharacterization is complete with respect to all financial data: *X* pays out $1,060,000 to its employee and shareholders, *A* is left with $730,000 ($200,000 plus $430,000 plus $100,000), and *B* is left with $330,000. These three totals match those that are actually observed. Once again, no attempt is made to match the after-tax reality, for the starting point of the exercise is to deny *X* the excessive deduction and then to collect more tax.[30]

That this recharacterization requires *X* to borrow money or to commit future revenues in order to pay the tax and dividends[31] contained in (e) is not terribly troubling in itself because such financing is sometimes utilized in reality.[32] Approach (e), however, can be faulted as incomplete for failing to include an important piece of evidence regarding *X*'s behavior, despite the fact that (e) is complete as to financial data. *X*'s actual behavior can be characterized as distributing all after-tax profits as dividends, a strategy that is the paradigm of virtue in a two-tier corporate tax system. The approach in (e), however, characterizes *X* as paying out $860,000 in dividends when its after-salary, after-tax profits were only $792,000. A skeptic could argue that one does not know *X*'s intentions and that it is pointless to look beyond the money actually distributed in order to discern a dividend strategy. On the other hand, it is probably more accurate to imagine *X* as having signalled that it will distribute all after-tax profits to its shareholders in the form of dividends than it is to insist that *X* planned to distribute $660,000 regardless of its financial state. Viewed in this manner, (e) is as incomplete as (d), although (e) contradicts a behavioral, rather than a financial, event.

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[30] Once again, to match post-tax reality would be to accept as given the total bill as drawn by the taxpayers.

[31] This assumes away the possibility that some part of the dividends paid may be recoverable from the directors of the corporation who may have violated whatever solvency standard state law has established for such payments. For a discussion of limitations on dividend distributions, see W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 1335-1403 (5th ed. 1980).

[32] When *X*, for example, mistakenly underassesses its tax liability, pays out large dividends, and then discovers a remaining tax liability, one assumes that *X* is expected to dip into its reserves or borrow in order to finance its obligation. *See* recharacterization (f), *infra* at text preceding note 33.

Only a more aggressive and perhaps absurd recharacterization can achieve completeness with respect to both financial and behavioral observations:

> (f) Imagine *X* as paying a $200,000 salary, somehow *mistakenly* paying $340,000 rather than $408,000 in taxes, and paying out its apparent after-tax profits of $860,000 to *A* and *B*. Only later does *X* realize its error and send $68,000 more to the Internal Revenue Service, some of which *X* must borrow or draw from reserves. Complete the transaction with a gift of $100,000 from *B* to *A*, leaving *B* with the $330,000 and *A* with the $730,000 they enjoy in reality.

This approach is complete. Inasmuch as the tax consequences of the "error scenario" illustrated in (f) are no different from those generated by (e), there is little reason to pursue this recharacterization strategy. If (f) is not perceived as any more arbitrary than its competitors, then it illustrates a general trait of recharacterizations: stories that are complete with respect to observable financial data can be modified and made complete with respect to behavioral events. On the other hand, because the incorporation and subsequent correction of an error makes a recharacterization such as (f) less *brief*, or just too absurd, and brevity is either normatively attractive or turns out to be predictively useful, one may prefer to choose between completeness with respect to financial data and completeness with respect to observed behavior.[33]

Even though litigants, including the Commissioner, have not tried an equal treatment approach along the lines of (d), (e), or (f), an attempt to develop predictive tools for tax law must conclude that none of these last three approaches has much chance of success. It would be a mistake, however, to leave this extended example with the impression that since (f) is not adopted in tax law, completeness is not a useful predictive tool. In the first place, completeness is more easily attained and more useful in other settings than it has been in (f).[34] More generally, it may be that the rejection—if disuse can be regarded as rejection—of these equal treatment approaches should be blamed on the fact that they are not brief. Each of these recharacterizations requires the extra step of a gift from *B* to *A* to achieve any sort of completeness at all, and (f) is doubly long-winded because it also requires an extra tax

[33] It is worth noting that approach (d) is not aimed perversely away from completeness with respect to financial data. The gift from *B* to *A*, for example, may make (d) more awkward in some sense, but it is included in order to make (d) less incomplete. Approach (d) is as complete as it can be, given real nonfinancial constraints.

[34] *See, e.g.*, transactions (i), (j) and (k), at *infra* text accompanying notes 52-62.

payment. Finally, one might be disinclined to favor (d), (e), or (f) because each requires *B* first to receive and then to part with some money distributed by *X*. *B*'s bank account is described in these recharacterizations as overshooting its mark and then backtracking for the sake of completeness. The recharacterizations are therefore indirect. On the other hand, given that in reality shareholders often receive dividends and then reinvest them, thereby initially overshooting their eventual liquidity positions, this sort of backtracking is not terribly different from the legal and behavioral norms of corporations and their shareholders. In any event, since the role of indirectness as a predictive tool is clearer in other settings yet to be explored, there is no reason to pursue this alternative explanation of the lameness of (d) and its cousins.

B. *Recharacterizing Stock Redemptions and Bootstrap Acquisitions*

1. Simple Redemptions

Perhaps the best known recharacterization problem in corporate tax law concerns "bootstrap acquisitions," in which a buyer emerges with full ownership of a corporation that is smaller in size than it had been in the hands of the seller, or previous owner.[35] Before exploring such transactions it is useful to review first the general treatment of stock redemptions.

Imagine a corporation, *Y*, with 100 shares outstanding, \$150 in assets, and \$50 in its earnings and profits account.[36] If a single shareholder owned all the stock of *Y* with a basis, or cost, of \$100, and *Y* redeemed one-half of its outstanding stock for \$75, the tax consequences would be clear. The attempted "redemption" is not non-pro rata, but is instead equivalent to a dividend.[37] The shareholder would

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[35] *See* B. BITTKER & J. EUSTICE, *supra* note 1, ¶ 9.07 (describing bootstrap buyouts as those in which acquisition is financed in part with the target corporation's own excess cash or liquid assets).

[36] Subchapter C of the Internal Revenue Code sets up a two-tier tax on corporate earnings. In the context of an ongoing corporation, it does this in part by taxing the recipient's dividend distributions as income, rather than by giving immediate credit for each shareholder's investment, so long as the distributing corporation's earnings and profits account—essentially a current and cumulative picture of the corporation's profitability—is positive. *See* I.R.C. §§ 301(c), 316(a) (1982); I.R.C. § 312(a) (1982 & Supp. III 1985). In the absence of earnings and profits, dividend distributions are accorded exchange treatment, and gain is measured as the difference between that which is received and the distributee's basis in her stock. *See* I.R.C. § 301(c)(3)(A) (1982).

[37] I.R.C. § 302(b) (1982) (providing for exchange treatment only when the redemption either meets the safe harbor of § 302(b)(2), with a 20% drop in ownership share, or "is not essentially equivalent to a dividend"). The single shareholder still owned 100% of the corporation after the "redemption" with \$75, indicating that she received a dividend.

then have dividend income of $50 and her basis in the remaining shares would decrease to $75,[38] while *Y*'s earnings and profits account would go down to zero.[39]

This dividend equivalence of a perfectly pro rata redemption is fundamental and obvious in the framework of subchapter C. When a capital gains preference or deduction is in place, as was the case before the Tax Reform Act of 1986,[40] it is especially clear that a proportionate redemption must be treated as a dividend rather than as a sale of stock entitled to capital gain treatment. Without such treatment, shareholders could too easily convert all dividends taxed at ordinary income rates into capital gains by uniformly surrendering a fraction of their shares at the time of corporate distributions. The repeal of the capital gains preference, however temporary,[41] does not leave taxpayers indifferent as to whether distributions they receive are branded as dividends or as redemptions entitled to "sale or exchange," or capital gain, treatment.[42] Capital gains are still attractive under the 1986 Act not only because capital losses may be used to offset capital but not ordinary gains[43] but also, and more importantly, because exchange treatment permits the shareholder to get immediate credit for her basis in the shares redeemed. The denial of exchange treatment in a redemption means that

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[38] *See* I.R.C. § 301(c)(2) (1982).

[39] *See* I.R.C. § 312(a) (1982 & Supp. III 1985). Note that if one wants this rather obvious recharacterization to be entirely complete, it is necessary to imagine a reverse stock split in which the corporation, which can show that only 50 shares are outstanding after 50 have been "redeemed," is deemed not only to have paid a simple dividend but also to have called for every two outstanding shares to become one. *See supra* note 27.

[40] I.R.C. §§ 1201, 1202 (1982) (28% marginal rate on net capital gains of corporate taxpayers and 60% deductions on capital gains for individuals). The Tax Reform Act of 1986, Pub. L. No. 99-514, § 311, 100 Stat. 2085, 2219 (1986) [hereinafter 1986 Act], eliminated this preferential treatment.

[41] Most observers believe that some capital gains preference will reappear. The return of preferential treatment is foreshadowed by the fact that the 1986 Act left in place all the definitions and statutory segments associated with capital gains. *See* H.R. CONF. REP. No. 841, 99th Cong., 2d Sess. II-106 (1986) (noting that one reason for preserving the current statutory structure for capital gains is "to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase."); Faber, *Capital Gains v. Dividends in Corporate Transactions: Is the Battle Still Worth Fighting?*, 64 TAXES 865, 866 n.6 (1986) (citing Conference Committee Report No. 841's reference to possible reinstatement of rate differential). Indeed, the 1986 Act even added such provisions, as in new § 336(a)'s use of the word "distributee," which threatens § 1239 in the future. *See* I.R.C. § 336(a) (1982 & West Supp. 1987); I.R.C. § 1239 (1982 & Supp. III 1985 & West Supp. 1987). If or when tax rates rise in the near future, the capital gains preference will surely be thought of as a wise means of diminishing the "lock-in" effect of the system's recognition requirement.

[42] "Sale or exchange" and especially "exchange" are the terms often used in the Code to signal nondividend treatment. *See, e.g.*, I.R.C. § 301(c)(3)(A) (1982) ("sale or exchange"); I.R.C. § 302(a) (1982) ("in exchange").

[43] *See* I.R.C. § 1211 (1982 & West Supp. 1987).

the entire value of the distribution is taxed as current ordinary income, with basis recovery postponed until either a true exchange takes place or the corporation's earnings and profits account is depleted.[44] In short, if a sole shareholder sells some of her shares back to the corporation, the Code ignores the paper shuffling involved and simply treats that which is distributed by the corporation as a dividend. Similarly, if a corporation has more than one shareholder and it carries out a perfectly pro rata redemption, one hardly needs the explicit statutory instructions provided by sections 301 and 302 to decide that the distributions must be treated as dividends.

Consider, then, the more interesting case of a non-pro rata redemption. If corporation *Y* has two equal shareholders, *C* and *D*, and it redeems out *C* entirely, many recharacterizations are possible.[45] Inasmuch as *Y* could hardly pay out money without *D*'s approval,[46] one

[44] Section 302(d) states that a redemption that does not qualify for exchange treatment under § 302(a) shall be treated as a § 301 distribution, *see* I.R.C. § 302(d) (1982), and under the dividend rules of § 301(c), money received to the extent of corporate earnings and profits is first treated as income and is only later treated as a return on investment, with recovery of basis, after the earnings and profits account is depleted.

[45] Taxpayers cannot simply recharacterize after the fact and expect that the papers they have signed and the chronology they have followed will be irrelevant. A well-advised taxpayer will, instead, assess the acceptable characterizations in advance and then act accordingly. Of course, some tax treatments become so acceptable that the Commissioner or the Code eventually consent to given tax consequences even when taxpayers' behavior has not perfectly conformed to the recharacterizations associated with such treatments. *See infra* note 77 (noting an area in which formalism has come to matter less over time).

[46] The notion that the remaining shareholder is taxed because the shareholder is benefited by the elimination of fellow owners is vaguely suggested by Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929), which held that an employee realized income when his legal obligations were discharged by his employer. One might argue analogously that *Y* has a relationship with *D* not unlike that of employer and that to the extent that the redemption of *C* may benefit *D* by allowing her to become the sole shareholder of *Y*, *Y* has improved *D*'s position much like the employer in *Old Colony* improved the employee's position. On the other hand, in the redemption context, *C* must surely realize that she is losing out or that *D* looks forward to a prospective benefit. One would expect, therefore, that *C* will extract from *D* a payment that reflected the benefit, if any, of being the sole shareholder. The analogy to *Old Colony* is most useful as a way of saying that since an attribution argument rather than evidence of a receipt was sufficient to trigger taxation, so too in the redemption context, the law *could* use *C*'s exit as something to attribute to *D* as susceptible to taxation. For another case utilizing the same approach, see Montgomery Eng'g Co. v. United States, 344 F.2d 996, 997 (3d Cir. 1965) (per curiam) (holding that a payment to widow of former executive and shareholder was a dividend to remaining, controlling shareholder because payment was meant to right the wrong that the remaining shareholder thought had been done to the widow by her husband). As this citation suggests, it is not necessary that *one* approach be selected and then used even when facts suggest that some other approach would be more fitting. The appropriate question, instead, is which characterization ought to be insisted upon, or at least found acceptable, in the absence of such special facts.

could recharacterize the non-pro rata redemption as follows:

> (g) Imagine *D* as purchasing *C*'s shares for $75 and *Y* as then distributing $75 to its sole shareholder, *D*, in return for half of her shares.

Assuming that *C*'s basis was $50, *C* reports a capital gain because of the $25 in appreciation of *Y* stock in her hands. *D* reports $50 of income, which wipes out *Y*'s earnings and profits account, and *D* reduces her basis in the remaining stock she holds to $100.[47] The dividend equivalence of the redemption of *D*, now a 100% shareholder, is, as described earlier, fundamental.[48] Thus, one can view the redemption of *D* in the first part of recharacterization (g) as real but yielding dividend income under section 301. Alternatively, (g) can be seen as nothing more than a pro rata dividend under sections 301 and 302, followed by a reverse stock split in order to leave 50 shares outstanding and to achieve completeness for the transaction.

An alternative recharacterization would be the following:

> (h) Utilize the strong form of the equal treatment idea and insist that, when in doubt, all corporate distributions should be pro rata. This approach suggests a distribution by *Y* of $75, with *C* and *D* each receiving $37.50 in a pro rata redemption. *C* and *D* must each report $25 of income. *Y*'s earnings and profits account is eliminated, and the remaining $12.50 reduces the shareholders' stock bases to $37.50. *D* can then be characterized as using the $37.50 she has just received to purchase *C*'s shares, which are worth exactly $37.50 after the dividend, resulting in a basis of $75 in all of *D*'s shares.[49]

Again, this event can be described either as a normal dividend distribution followed by a reverse stock split in order to achieve completeness or as a pro rata redemption that is simply "equivalent" to a dividend. The pro rata redemption described above, though, might be regarded as more brief because there is no need for the additional step

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[47] *D*'s basis in one-half of her shares at the beginning of the recharacterization was $50. Her basis in all the shares became $125 after she purchased *C*'s shares for $75. Finally, the last $25 distributed to *D*, after $50 of dividend income depleted *Y*'s earnings and profits account, reduced this basis to $100 under I.R.C. § 301(c)(2) (1982).

[48] *See supra* text accompanying notes 37-40.

[49] This recharacterization was suggested by Marvin Chirelstein in Chirelstein, *Optimal Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 YALE L.J. 739, 749 (1969).

of a reverse stock split.

Note that this equal treatment recharacterization, unlike several of the recharacterizations sketched in Section A of Part II,[50] does not require the imputation of a gift or the inclusion of any other extra step that would make (h) less brief than (g). In the absence of any evidence of affection between donor and donee, this ability to avoid a gift scenario may seem especially attractive.[51] Two further alternatives follow:

> (i) Simply regard *C* as selling stock to *Y* just as if she had sold stock to a stranger. *C* pays a tax on her gain of $25. The recharacterization does not touch *D*; her basis and *Y*'s earnings and profits accounts remain as they were, at $50 each.
> (j) Regard *C*'s departure as a mini-liquidation.[52] There is, then, a gain of $25 to be reported by *C*, as in (i), but *Y*'s earnings and profits account is diminished to $25.

Given that no corporate level tax is at issue in these recharacterizations, either because *Y*'s assets are presumed to be in cash form or to contain no untaxed appreciation, it is easy for these recharacterizations to be complete with respect to *both* financial data and other observed events.[53] In all these recharacterizations, as in reality, *D* emerges as the sole owner of a $75 corporation, and *C* exits with $75 to spend as she

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[50] *See supra* text accompanying notes 11-34.

[51] The presence or absence of relationships that are likely to generate such affection seems to affect the characterization of cases. *Compare* Harolds Club v. Commissioner, 340 F.2d 861, 865-66 (9th Cir. 1965) (characterization of large salary payment to nonshareholding father not unrelated to finding that father dominated his sons) *with* Home Interiors & Gifts, Inc. v. Commissioner, 73 T.C. 1142, 1160 (1980) (sustaining taxpayer's deduction of enormous salaries to three officers in setting in which almost half the stock was owned by persons unrelated to two of these officers, and all or nearly all was owned by persons unrelated to the third officer).

[52] "Mini-liquidation" refers not to a partial liquidation as defined in I.R.C. § 302(e) (1982), but rather to an imaginary slice of the treatment offered in I.R.C. § 331 (1982); I.R.C. §§ 334(a), 336 (1982 & West Supp. 1987). A redemption of 50% of a corporation's stock might simply be treated as one-half of a complete liquidation. The exchange treatment that recharacterization (j) assigns to *C* is thus simply borrowed from § 331. The proportional reduction in the earnings and profits account is taken from the fact that after a complete liquidation (except one carried out under I.R.C. § 332 (1982 & West Supp. 1987)), this account disappears entirely. This mini-liquidation recharacterization is inspired by the fact that under prevailing law, earnings and profits decrease in a redemption. *See* I.R.C. § 312(n)(7) (Supp. III 1985 & West Supp. 1987) (§ 312(n)(7) was modified in 1987 only to the extent that the section number changed from § 312(n)(8) to § 312(n)(7); the text of the provision was unaltered).

[53] If a corporate level tax were owed in some of these recharacterizations, then the problem noted in Section A of Part II arises: the extraction of this tax would affect the amount of money available for distribution, so that even pre-tax completeness would be difficult to achieve. *See supra* text accompanying notes 28-29.

pleases. Only approach (g) is unnerving in a way that is labeled indirect rather than incomplete. It begins with an unrecognized gain and ends with an unrecognized loss in *D*'s hands; *D* had $50 of unrecognized gain, and yet $75 is now taxed. It is odd in aesthetic terms for a recharacterization to overshoot its mark and then backtrack in this way. However, because this transaction is explicitly handled by statute, it is best once more to defer discussion of the predictive utility of this third recharacterization rule, directness.

The consequences that attach to the redemption of *C*'s stock are explicitly described in sections 302 and 312 of the Internal Revenue Code and might be described as patterned on (i) or (j). Section 302 provides that for *C* the redemption will be treated as an exchange,[54] while *D*, by implication, is left unaffected. Section 312(n)(7) calls for a proportional reduction in earnings and profits so that *Y*'s earnings and profits account is reduced by 50% to $25.[55] These treatments are exactly the same as those generated by the recharacterization proposed in (j). One might simply conclude, therefore, that from a set of the four complete recharacterizations just illustrated, Congress simply chose the one that was friendliest to taxpayers, and the one which, coincidentally, did not conform to a strong equal treatment rule.

A minor problem with this conclusion is that section 312(n)(7) may be motivated by something unrelated to redemptions. Some or all stock sales might generate, along with the taxes they extract from sellers of stock, a basis step-up in assets held at the *corporate* level, if only to avoid the two-tier taxation of pre-incorporation appreciation. Such a scheme of corresponding step-ups would be administratively difficult to execute;[56] however, when stock is sold back to the issuing corporation itself, the administrative burden of keeping track of stock sales is lighter, and a reduction in earnings and profits may be a convenient proxy or substitute for such a rule.[57] This tangential argument sug-

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[54] *See* I.R.C. § 302(b) (1982).

[55] *See* I.R.C. § 312(n)(7) (Supp. III 1985 & West Supp. 1987).

[56] Even apart from administrative difficulties, one could never simply give an *x%* step-up in return for an *x%* stock sale, for this creates a "correspondence fallacy." The fallacy is that gain may be recognized where it is subaverage—because of high basis, for instance—while the step-up is then taken on assets that are average. *See* Levmore, *The Positive Role of Tax Law in Corporate and Capital Markets,* 12 J. CORP. L. 483, 496 (1987). This fallacy is mitigated in our system by giving such corresponding treatments only when 80% recognition events are involved.

[57] This is true because it is much easier for the distributing corporation to keep track of its redemptions than for it to monitor the trading of its shares in the marketplace. To the extent that one day a more sophisticated rule might call for a basis step-up or an earnings and profits reduction corresponding not simply to the percentage of traded or redeemed shares but to the magnitude of previously untaxed appreciation that is accounted for in these trades it would again be easier to keep track of this matter in

gests, but hardly proves, that the earnings and profits reduction called for in section 312(n)(7) is related to something external to the redemption itself. Since such an argument is not completely without merit, however, it seems best to allow for the possibility that the treatment of redemptions in section 302(a) is as described in (i)—as simply consisting of an everyday sale of stock. Only when such a sale is used to escape dividend treatment, as when the sale is by a sole shareholder to her corporation, does the Code deny the normal sale-of-stock treatment.[58]

This obstacle to characterizing the nature of section 302's treatment of redemptions is but a small problem in the broader examination of whether completeness, brevity, and directness are useful tools in predicting successful recharacterizations. A more serious problem is the familiar one of interpreting the scope and power of the statute at issue.[59] Had the Internal Revenue Code not explicitly addressed the question of the proper treatment of the complete redemption of a shareholder like *C*, *C* and *D* might have argued for approach (i) or (j), and the Commissioner might have sought the tax revenues implicit in (g) or (h). At some point, the courts would have resolved the matter in favor of a particular characterization or set of consequences. But when Congress does choose a result in one setting, as it did in section 302(a), it is not clear what precedential value that choice provides for courts considering other recharacterizations.

If, for example, section 302(a) had matched approach (h), would that mean that approach (d), (e), or (f) was necessarily called for in the treatment of excessive salaries? One could contend that the equal treatment spirit evinced in the statute should be carried over to other settings. One could argue just as forcefully, however, that by drawing on (h) in the context of redemptions only, Congress intended that the equal treatment rule be limited to that context. This question appears everywhere in law, of course, for virtually no statute addresses every eventuality.[60]

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the context of redemptions alone.

[58] *See* I.R.C. § 302(b)(1), (b)(2) (1982) (providing for exchange, or capital gain, treatment when redemption does not have the effect of a dividend and offering safe harbor of exchange treatment for a shareholder who has less than 50% ownership and whose ownership share, after attribution from related parties, is less than 80% of what it was prior to redemption).

[59] *See* Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are to Be Construed,* 3 VAND. L. REV. 395, 401 (1950) (skeptically noting the available and opposite forces of "thrust": "[a] statute cannot go beyond its text," and "parry": "[t]o effect its purpose a statute may be implemented beyond its text").

[60] *See* Phelps, *Factors Influencing Judges in Interpreting Statutes,* 3 VAND. L.

In order for a court to determine whether the language of a tax or any other kind of statute possesses centripetal or centrifugal force, it should tackle each situation on its own terms and look for the best result in every instance. If there is a compelling reason for choosing approach (i) or (j) in the context of section 302 and this reason is applicable in other settings, then this statutory interpretation should be extended. On the other hand, if a given recharacterization rule is more attractive than the approach reflected in a statute that is only loosely related to the matter at issue, then there is no reason to suppress the attraction. In the latter case, it is reasonable to argue that the statutory solution should be confined within the borders it establishes.[61]

2. Bootstrap Acquisitions

Assume that *C* owns all the stock of corporation *Y* and decides to sell her interest to *D*. If *D* has only $75, *C* might still depart with $150 if *Y* shrinks to one-half its former size. Such a transaction is commonly known as a bootstrap acquisition because the target corporation, *Y*, assists in the purchase of itself. Very different tax treatments attach to such a transaction, depending on whether the recharacterization incorporates the equal treatment rule and whether the buyer is introduced at the outset or at the conclusion. Imagine the following recharacterization:

> (k) *C* first sells one-half her *Y* stock to *D* for its fair market value, which is $75. *Y* then redeems *C*'s remaining shares for $75.

In this plan, *C* has a capital gain of $25 and *D*'s basis in her new stock is $75 as a result of the stock purchase by *D*. As a consequence of the redemption, *C* reports another $25 gain under the exchange treat-

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REV. 456, 469 (1950) ("Until each problem arises, a statute has no full meaning.").

[61] It is unrealistic or even wasteful to wait for clear statutory language on every matter. *Compare* Levmore, *Interstate Exploitation and Judicial Intervention,* 69 VA. L. REV. 563, 568 (1983) ("Until the legislative branch acts, courts do what they think wise, or, where possible, what they discern to be legislative policy.") *with* Isenbergh, *Musings on Form and Substance in Taxation,* 49 U. CHI. L. REV. 859, 879-83 (1982) (reviewing B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS (1981)) ("extrastatutory or remedial forays by the courts in tax cases" provide "a fertile source of bad law"). Although consistency among decisions made by groups may at times be difficult, *see* Easterbrook, *Ways of Criticizing the Court,* 95 HARV. L. REV. 802, 811-13 (1982), it is not pointless, *see* Deutsch, *Precedent and Adjudication,* 83 YALE L.J. 1553, 1583-84 (1974). There is much to be said about the definition of consistency and the intuitive sense of what constitutes contradiction. The strategy in this Article is to introduce the rough notion of consistency as a useful positive tool in tax law but to reserve a more detailed exploration of consistency in tax, and perhaps in other law, for a future effort.

ment of section 302(b)(3), and *Y*'s earnings and profits account is reduced to $25 under section 312(n)(7). Since (k) does not extract a tax early in the recharacterization, completeness in this recharacterization is easily attained. *C* actually emerges with $150 pre-tax, while *D* spends $75 and is the sole owner of a $75 company. The recharacterization is thus complete, and the stock sale and redemption are at prices that fairly reflect the value of *Y*.[62] Alternatively, the next variation is also possible:

> (l) Starting the transaction as in (k), *C* sells one-half of her stock to *D* for $75. *C* has a gain on this exchange of $25 and *D*'s basis in her new *Y* stock is her purchase price of $75. Now, following the equal treatment suggestion that all ambiguous distributions out of a corporation be characterized as occurring pro rata, imagine Y as redeeming $37.50 of stock from each shareholder. Finally, *C* sells her remaining shares to *D* for their fair market value of $37.50.

The dividend equivalence of this pro rata redemption is fundamental and, as a statutory matter, is compelled by sections 302 and 301.[63] *C* and *D* report $25 of income each because there was only $50 in *Y*'s earnings and profits account. Each shareholder then reduces her basis by $12.50: *C*'s basis drops from $50 to $37.50, and *D*'s basis drops from $75 to $62.50.[64] When *C* sells her remaining shares to *D*, these shares are worth $37.50 because they represent one-half of a $75 company. The sale price only allows *C* to recover her basis, and it raises *D*'s basis in all her shares to $100. *Y*, of course, is now worth $75. At some point in the future, *D* will have a $25 loss to recognize.

The equal treatment style of recharacterization (l) is still attractive. The unrecognized loss to *D*, however, smacks of artificiality. The recharacterization has increased tax liabilities and continues to satisfy the requirements of completeness only because the government will owe money to *D* in the future. If the approach in (l) had actually extracted tax payments and concluded with the government's owing a refund to *D*, this sort of objection would be stronger still. The notion of indirectness, introduced at the outset of this Article with the metaphor of ex-

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[62] These results are both incorporated in recharacterization (k). *See infra* note 83 for a complete variation of (k) that is even more attractive from the taxpayers' perspectives.

[63] *See* I.R.C. § 301 (1982 & West Supp. 1987); I.R.C. § 302 (1982).

[64] *See* I.R.C. § 301(c) (1982). Approach (l) could have simply called for a pro rata dividend distribution rather than an equivalent redemption, but completeness might have again required a reverse stock split. The form of the recharacterization is thus brief.

tremely circuitous travel and further illustrated in (g) above,[65] reflects a sense that such artificiality is too forced for tax law. In the context of a tax system that seeks eventually to have all gains and losses recognized, it is strange to recharacterize in a way that begins with both an unrecognized gain and no unrecognized losses and ends with an unrecognized loss. Approach (l), after all, does not simply incorporate an unrecognized loss or gain; it begins with an unrecognized gain, *overshoots* its implicit mark of complete recognition, and then later backtracks to this mark.

The approach described in (l) is also indirect in its description of *D*'s financial commitment to *Y*. *D* invests $75, receives $37.50 in return, and then invests this $37.50 by purchasing *C*'s remaining shares. As noted earlier,[66] this sort of backtracking is not unusually indirect because shareholders often receive dividends and then reinvest in the distributing corporation.[67] A cynic might say that what is really inexplicable is not the backtracking, but the voluntary declaration of heavily taxed dividends in the first place. Given that corporations do declare dividends and that some shareholders do reinvest these distributions and pay tax on the turnaround, it is possible to distinguish (l)'s backtracking with respect to unrecognized gains and losses from the backtracking path of *D*'s financial commitment. This distinction would justify labeling the first pattern alone as indirect.[68]

If this distinction holds, it is arguable that (l) is a poor testing ground for the rule that successful recharacterizations are direct because the backtracking that (l) requires is the product of an explicit congressional decision, which signals very little about the resolution of problems not explicitly legislated.[69] In other words, the descriptive utility of a positive tool may be best judged with respect to common law, rather than with respect to statutory results such as the approach in (l).[70] The unrecognized loss that materializes in recharacterization (l),

[65] *See supra* text accompanying notes 47-48.

[66] *See supra* text following note 34.

[67] Although § 305(b) appears internally indirect by regarding a change in conversion ratios as a distribution with respect to stock followed by a reinvestment, *see* I.R.C. § 305(b), (c) (1982), in reality, this hardly weakens the notion of indirectness. Such rules are necessary to prevent complete avoidance of dividend taxation. Similarly, this Article searches for a positively useful core of the indirectness idea. *See also supra* note 17 (distinguishing statutory from judicial decisions as material for positive theories).

[68] This Article will later address whether this label is a useful one. *See infra* text accompanying notes 82-84.

[69] *See supra* text accompanying notes 59-61.

[70] Some positive tools are aimed at legislative results. In some settings, the statutory constraints can be accepted as externally given, and litigants, courts, and theorists can be understood as making law and sense out of nonstatutory decisions. When courts must fill the gaps between statutory constraints, however, parties become able to

after all, is a direct product of our peculiar two-tier corporate tax system. When, for example, a corporation with negative or zero cumulative earnings and profits but positive earnings and profits in the current year makes a pro rata distribution, its shareholders must report income for the current year even though this distribution depletes the corporation's assets in such a way that a subsequent sale by the shareholders of their stock would allow them to recognize losses.[71] It is thus rather common in our tax system to see backtracking with respect to recognition of income and loss at the shareholder level. Hence, when a dividend generates an unrecognized loss, as it does in (l), labeling as indirect the recharacterization of which this dividend is a part may not prove useful. Since recharacterization (l) is arguably indirect, it is useful to examine other recharacterizations of bootstrap acquisitions.

> (m) *D* first purchases all of *C*'s shares, and *Y* then redeems one-half of its shares from *D*. *C* has a capital gain of $50. The temporary basis of the *Y* stock in *D*'s hands is equal to D's purchase price of $150, and there is a $75 dividend to *D*. This is a dividend because the distribution to her as sole shareholder is fundamentally equivalent to a dividend. Receipt of this dividend requires *D* to report $50 of income, reducing *Y*'s earnings and profits account to zero, and then reduces *D*'s stock basis by $25 to $125, although this stock is worth $75.

Although the severe treatment of *D* in recharacterization (m) follows from the idea that *Y* has satisfied *D*'s debt to *C* or otherwise improved *D*'s position,[72] the large unrecognized loss in *D*'s hands[73] makes

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recharacterize transactions in ways that vary with the given statutory constraints. The predictive value of recharacterization rules, therefore, should be judged with respect to common law, rather than legislatively mandated results.

The expression "common law" as used here is meant only to distinguish judicial from legislative results and not common law from civil law. Indeed, even a more statute-based or "civil law" system would still require that interpretative rules fill the gaps between statutes, and it might also provide fertile terrain in the search for recharacterization rules.

[71] Imagine, for example, that *W* corporation with $300 in assets loses $50 in its first year, earns $50 in this its second year of operation, and is owned by sole shareholder *A* who has a basis of $300 in her *W* stock. If *W* now declares a dividend of $50, *A* will have $50 of ordinary income under § 301(c)(1) because of § 316(a)'s "nimble" dividend rule, and her basis in the *W* stock will remain at $300. *See* I.R.C. §§ 301(c)(1), 316(a) (1982). After the dividend, however, *W* contains only $250 in assets, so that if *W* is liquidated or *A* sells her stock for $250, *A* will recognize a $50 loss.

[72] *See supra* note 46.

[73] *Y* is worth $75, and, yet, *D*'s basis in all the outstanding *Y* stock is $125, yielding an unrecognized loss of $50.

this approach quite indirect. *D* begins with no investment in *Y*, increases her investment to $150, and then becomes a $75 investor. The volatility in *D*'s financial commitment to *Y*, moreover, is not analogous to a dividend reinvestment plan.[74] Despite its indirectness, (m) may be a worthwhile recharacterization. The predictive value and normative power of indirectness remains, of course, to be demonstrated.[75]

The indirectness in recharacterization (m) can be eliminated by reversing the order of its components:

> (n) *Y* first redeems one-half of *C*'s shares, and then *D* purchases *C*'s remaining shares. *C* reports income of $50 because the "redemption" is perfectly pro rata, and $25 goes toward reducing her stock basis to $75. As a result, there is no gain on the sale to *D* and no gain or loss remaining to be recognized.

Approach (k) was affirmed in the well-known case of *Zenz v. Quinlivan*,[76] a decision to which the Commissioner has acquiesced.[77] It

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[74] Earlier examples of indirectness involved the familiar and seemingly indirect pattern of dividend reinvestment in which a shareholder receives a dividend and then immediately reinvests it. Here, however, *D* does not reinvest that which she receives in the dividend distribution. *See supra* text following note 34 (discussing the backtracking involved in dividend reinvestment).

[75] *See infra* text accompanying notes 158-159.

[76] 213 F.2d 914, 917-18 (6th Cir. 1954) (permitting the form chosen by a taxpayer in a bootstrap acquisition to prevail and yield only capital gain, or exchange, treatment to the departing shareholder).

[77] *See* Rev. Rul. 54-458, 1954-2 C.B. 167, 168 (following *Zenz* under the 1939 Code); Rev. Rul. 55-745, 1955-2 C.B. 223, 224 (following *Zenz* under the 1954 Code at least for *complete* departures of the selling shareholder). A taxpayer whose transaction resembles (m) or (n) in form *may* be treated as receiving a dividend. The Internal Revenue Service now willingly gives the favorable treatment accorded in *Zenz* when the redemption is undertaken before the sale, so long as the steps are part of an integrated plan. *See* Rev. Rul. 75-447, 1975-2 C.B. 113, 114. Outside this narrow range, formalism can still be determinative. In Television Indus., Inc. v. Commissioner, 284 F.2d 322 (2d Cir. 1960), a dividend resulted to the incoming shareholder exactly as it would in (m), above, because he borrowed money to complete the purchase of all the shares and then had the corporation redeem some of his shares in order to repay the loan. *See id.* at 324. The best argument against such formalism is that badly advised taxpayers alone will suffer. This is especially interesting and puzzling because corporate tax law is often devoid of such formalism, as the above revenue ruling illustrates.

The fact that the formal ordering of events in *Zenz* need not be followed at least in some situations in order to achieve the tax consequences of *Zenz* hardly detracts from the idea that these tax consequences once depended on the order in *Zenz;* formal requirements are only relaxed because formal order could have been followed. For a survey of when formalities are required in situations related to *Zenz*, see S. SURREY, *supra* note 11, at 556-64.

On the other hand, a *corporate* seller or buyer that prefers dividend to exchange treatment because of § 243's intercorporate dividend exclusion, *see* I.R.C. § 243(a) (1982) (amended by Omnibus Budget Reconciliation Act, § 10221(a)(1), 101 Stat. 1330, -408 (1987)), is normally unable to style its transaction according to (m) or (n) and enjoy is a complete approach to bootstrap acquisitions but so are the other approaches just sketched. As a semantic matter, it is arguable that of these approaches, (k) alone fails to incorporate an equal treatment notion, for the others depict distributions, whether labeled dividends or redemptions, as occurring pro rata. This conclusion, however, ignores the spirit of the equal treatment idea. It suggests a preference for recharacterizations that not only support the traditional model of distributions to shareholders, but also reflect the notion that corporate actions require the agreement of a majority of or all affected parties. In fact, approaches (k), (m), and (n) all seem at odds with the equal treatment idea. Only approach (l) provides equal treatment because the acquired company in a bootstrap acquisition arguably benefits *both* the buyer, *D,* and the seller, *C,* by paying off the former's debt and by financing the latter's retirement. Since it is difficult to know which of these effects is greater, it seems appropriate to characterize the corporation as financing the buyer and seller equally. Neither the Commissioner nor the courts, however, have shown any inclination to treat bootstrap acquisitions in the manner suggested by (l). In light of the predictive futility of any equal treatment approach to the excess salary problem discussed in Section A of Part II,[78] as well as the legislative selection of (i) or (j) rather than (h) in a straightforward redemption,[79] it now seems reasonable to reject the equal treatment principle as a useful predictive tool for corporate tax law.

The selection in *Zenz* and in other cases[80] of the recharacterization illustrated in (k) may be attributed to a particular mode of statutory interpretation. Approach (k) is very much like (i) and (j) in that it is the complete recharacterization most favored by taxpayers because it

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such favorable treatment. *See, e.g.,* Waterman S.S. Corp. v. Commissioner, 430 F.2d 1185, 1195-96 (5th Cir. 1970) (disallowing tax-free dividend treatment in the context of a presale extraction of earnings and profits by a corporate sole shareholder because of a fear that such treatment would create a "new horizon of tax avoidance opportunities"), *cert. denied,* 401 U.S. 393 (1971). *Waterman* is modeled in recharacterization (n) because (n)'s pro rata redemption can alternatively be described as a dividend followed, if necessary, by a reverse stock split. *See* B. BITTKER & J. EUSTICE, *supra* note 1, ¶ 9.07. For a fuller discussion of situations involving corporate distributees, see *infra* note 84.

Finally, note the following arrangement:

> (o) Liquidate *Y* and sell $75 of assets to *D* who will reincorporate them. Assuming no untaxed appreciation in *Y*'s assets, only *C* reports a capital gain.

This approach fails because it is *too* powerful. A discussion of liquidation-reincorporation problems, however, is beyond the scope of this Article, although the four recharacterization rules are quite useful in dealing with these problems.

[78] *See supra* text accompanying notes 23-34.

[79] *See supra* text accompanying notes 56-61.

[80] *See* B. BITTKER & J. EUSTICE, *supra* note 1, ¶ 9.07 (citing cases).

generates but one light tax. The decision in *Zenz* can therefore be seen as a decision to extend the generous statutory approach of section 302 to recharacterization questions beyond the scope of the statute.[81] One may be disinclined to make such a sweeping claim about *Zenz,* perhaps because such a claim necessarily implies that too many other recharacterization questions in tax law ought to be resolved in the taxpayer's favor. Even so, it is still possible to draw several narrower conclusions from the selection of (k).

The success of *Zenz* should generate confidence in the predictive utility of brevity or directness or both. Approach (l) includes a cross-sale from *C* to *D* and, therefore, contains three steps, while the competing recharacterizations, (k), (m), and (n), contain but two.[82] The brevity rule thus appears more powerful than the equal treatment principle. Alternatively, one can take the rejection of both (l) and (m) as evidence that directness is a useful tool because these recharacterizations, in contrast to (k), involve backtracking.

Neither brevity nor directness, however, distinguishes (n) from (k). Each of these recharacterizations is complete, direct, and brief. Although neither conforms to the equal treatment idea, at least neither incorporates an illicit non-pro rata distribution.[83] While the tools suggested in this Article will not uniquely predict which characterization will be chosen by the tax law, they are helpful in narrowing the possibilities.[84]

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[81] *See supra* note 59 and accompanying text.

[82] If the analysis includes a longer time horizon in the course of which gains and losses will all be recognized, (l) contains four steps, (m) has three steps, and (k) and (n) have two steps each.

[83] For a discussion of non-pro rata distributions, see *supra* notes 24-25 and accompanying text. Note also that the following variation on the approach in (k), purely an attempt to outflank *Zenz,* would surely fail:

> (k) *Y* issues *new* stock worth $75 to *D*. *Y* then redeems all of *C*'s stock for its fair market value, $150. *C* reports a $50 gain under the exchange treatment of § 302(b)(3) and *Y*'s earnings and profits account is reduced proportionately by two-thirds to $16.67 under § 312(n)(7).

See I.R.C. § 302(b)(3) (1982); I.R.C. § 312(n)(7) (Supp. III 1985 & West Supp. 1987).

This approach leaves *D* unaffected and is as friendly to *C* as is (k) or *Zenz*. But by *indirectly* expanding and then shrinking, *Y* claims a larger reduction in earnings and profits than was available in (k). This recharacterization clearly fails. Indeed, were it otherwise, a corporation could always issue new stock and then redeem out the new, temporary investors as a simple means of depleting the earnings and profits account. An easy way to think about the disallowance of such shams is to say that they are quintessentially indirect.

[84] Something other than recharacterization rules is also at issue in the choice between (k) and (n). Generally, an individual shareholder will prefer (k). When *C* is a corporation, however, (n) may be preferred because § 243 is then available to exclude from income all or most of the intercorporate dividend. *See* I.R.C. § 243(a) (1982)

C. *Characterizing Distributions in the Context of a Reorganization*

Another major testing ground for recharacterization rules involves the receipt of "boot"[85] in the context of a reorganization. Section 356 requires dividend treatment for a distributee if the boot received "has the effect of the distribution of a dividend," to the extent that "such an amount of the gain recognized [in the transaction] . . . is not in excess of [the distributee's] ratable share of the undistributed earnings and profits of the corporation."[86] Although the Commissioner first sought to establish that all distributions received by a continuing shareholder at the time of a reorganization were to be treated as ordinary income so long as earnings and profits and unrecognized gain were present,[87] it is now universally agreed that the language "has the effect of the distribution of a dividend" affords exchange, or capital gain, treatment when a distribution is sufficiently non-pro rata.[88]

(amended by Omnibus Budget Reconciliation Act, § 10221(a)(1), 101 Stat. 1330, -408 (1987)). It would be quite astonishing if the tax system permitted taxpayers to choose at will among various treatments and tax consequences in the absence of a clear legislative message that such choices were to be permitted. *See* Jassy, *The Tax Treatment of Bootstrap Stock Acquisitions: The Redemption Route vs. the Dividend Route,* 87 HARV. L. REV. 1459, 1475-83 (1974) (arguing that transactions that are of the same economic substance should be given consistent tax treatment). *But see* Kingson, *supra* note 4, at 895 (concluding that "despite the constant talk of substance and the search for economic benefit, form can permit a seller to achieve capital gain rather than a dividend" (citation omitted)); Correspondence, *The Deep Structure of Taxation,* 86 YALE L.J. 798, 803 (1977) (Professor Martin Ginsburg arguing that dividend distribution problems will not be solved by "tinkering with a definition" and that there are possible reforms involving elections by taxpayers that may be attractive).

Judges could permit a choice between (k) and (n), and the government could compensate for the resulting revenue loss. Such a choice might seem a bit odd, however, for it entertains fundamentally different or inconsistent descriptions of what amount to identical transactions. In any event, no such normative comments about inconsistent recharacterization approaches are required because courts have had little trouble rejecting recharacterizations by corporate sellers resembling (n). *See supra* note 77. It is no accident that this development followed *Zenz* chronologically. Having opted for (k) in that case, when (k) and (n) would each have been complete, direct, and brief, it may have seemed inconsistent to accept (n) in later cases. The discussion in the remainder of Part II suggests that such consistency, that is, the refusal to allow both (k) and (n) to characterize differently the same sort of transaction, may be a useful recharacterization rule. If so, nothing suggests that (k) and not (n) was destined to emerge, but there may be reason to think that (n) could not survive once (k) had been selected.

[85] "Boot" refers to consideration other than stock and securities (not in excess of the value of securities given up in a reorganization) of the corporate parties to a reorganization. *See* I.R.C. § 356(a)(1), (d) (1982).

[86] I.R.C. § 356(a)(2) (1982).

[87] *See* Commissioner v. Estate of Bedford, 325 U.S. 283, 288-92 (1945); B. BITTKER & J. EUSTICE, *supra* note 1, ¶ 14.34 (noting influence of "some imprecise statements in" *Bedford*). The Commissioner formally abandoned this viewpoint in Rev. Rul. 74-515, 1974-2 C.B. 118, 119-20, and in Rev. Rul. 74-516, 1974-2 C.B. 121, 121.

[88] The distinction between dividend and exchange treatment survives the 1986

Imagine, for example, that *Y* Corporation has assets of $100, that *E* is a 10% shareholder of *Y* with a basis of $8 in her *Y* shares, and that *Y* undertakes a tax-free reorganization with *Z*, a corporation with assets of $200. Virtually all of the shareholders of *Y* receive only stock of *Z*, but *E*, in return for her *Y* shares, receives $6 worth of the stock of *Z* and $4 in cash. *E* thus gives up $10 in value of *Y* stock and receives an equivalent package of cash and stock, which is a bit more than 2% of the stock of a company that now contains $296 of assets. This redemption of *E*'s shares is clearly non-pro rata,[89] so that even assuming no shortage of earnings and profits, the cash received by *E* is treated as part of an exchange. *E* reports a capital gain of $2 because her basis in the old shares was $8. *E*'s basis in the new *Y* shares is $6. If the distribution had the effect of a dividend, *E* would still only report $2 in income because section 356(a)(2), unlike section 301, limits this dividend treatment to *E*'s *gain*. *E*, however, would then be unable to offset this gain with capital losses. Moreover, if *E* received preferred stock in addition to cash, the preferred stock would be tainted under section 306 only if the distribution had the effect of a dividend.[90]

As a means of exploring the nature of distributions around the time of reorganizations, consider this merger between *Y* and *Z*, but imagine now that before the merger, *Y* has two 50% shareholders, individuals *F* and *G*. The deal that is struck between *F* and *G*, on the one side, and *Z*, on the other, calls for *Z* to receive all the stock of *Y* in

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Act, although it becomes less important. If the distribution qualifies as part of an exchange treatment, then it can be offset by capital losses and may qualify for installment sale treatment. *See* Faber, *Capital Gains v. Dividends in Corporate Transactions: Is the Battle Still Worth Fighting?*, 64 TAXES 865, 868-69 (1986) (discussing what significance the elimination of the preferential treatment of long-term capital gains in the 1986 Act will have in distinguishing between dividend and capital gain transactions). As the example in the text will demonstrate, the most important post-1986 difference between dividends and capital gains shrinks in the context of boot distributed around the time of a reorganization because § 356(a)(2), unlike § 301, limits the dividend treatment to the *gain* recognized by the distributee. *See* I.R.C. § 356(a)(2) (1982).

An investor who purchases *X* stock for $60 one day and receives a pro rata $20 dividend the next day has $20 of income under § 301(c)(1) (1982), if *X* has enough earnings and profits. This occurs even though the *X* stock may go down in value to $40. The loss recognition must await a future sale. If, instead, *X* merges with *W* and the investor receives *W* stock worth $40 and $20 in cash, then even if the cash is deemed as having been received pro rata, there is no dividend to the investor, who has no gain on the transaction.

[89] The text will describe different ways of measuring the extent of a distributee's disproportionality. *See infra* notes 91-100 and accompanying text. It is sufficient to note here that even if *E* is pictured as receiving $4 from *Y* in return for 4% of *Y*'s outstanding stock, rather than money from *Z* or *Y* for *Z*'s outstanding stock, she drops from being a 10% shareholder to a 6/96 or 6.25% shareholder, which easily qualifies her for exchange treatment under § 302(b)(2). See I.R.C. § 302(b)(2) (1982).

[90] *See* I.R.C. § 306(c)(1)(b) (1982).

return for $30 in cash and *Z* stock worth $70. *F* and *G*, each with a basis of $10 in the *Y* stock, agree to divide equally the two types of consideration received. The question, once again, is whether the cash received by *F* and *G* in this transaction should be treated as a dividend, or whether *F* and *G* are to have the advantages of capital gain, or exchange, treatment. The answer depends almost entirely on whether the distributions are characterized as made early or late in time, as the following competing recharacterizations demonstrate.

> (p) View the distributions to *F* and *G* as occurring before the reorganization. At that point, *F* and *G* each begins with $50 of equity in a $100 entity. After the $30 is distributed, each shareholder has $35 in a $70 entity.

Inasmuch as each shareholder's ownership percentage has not dropped at all, the distribution in (p) has "the effect of . . . a dividend."[91] Since each distributee has a gain of $40, assuming sufficient earnings and profits, the $15 received by each is all ordinary dividend income under the principles of section 301.[92] The Commissioner insists on the approach illustrated in recharacterization (p).[93]

Note that this prereorganization approach does not always preclude exchange treatment. Suppose, for example, that *F* and *G* had decided not to divide equally all the consideration received from *Z*, but had instead agreed that *F* would receive $23 in cash and $27 in *Z* stock, while *G* would receive $7 in cash and $43 in stock. *F*'s drop in *Y* ownership from 35/70, or one-half, to 27/70 would then meet the requirements set out in section 302(b)(2) for exchange treatment because her decrease from 50% to 38.6% exceeds the 20% drop in ownership that is required.[94] *F*, in this last example, would have $23 in capital gain that

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[91] Rev. Rul. 75-83, 1975-1 C.B. 112, 113.

[92] *See supra* note 36 and accompanying text.

[93] *See* Rev. Rul. 75-83, 1975-1 C.B. 112, 113.

[94] *See* I.R.C. § 302(b)(2) (1982) (requiring, for exchange treatment, that the ratio which the shareholder's voting stock bears to all of the voting stock of the corporation immediately after the redemption be less than 80% of the ratio which the shareholder's voting stock bears to all of the voting stock of the corporation immediately before the redemption); *see also supra* note 89 (noting that *E*'s reduction in ownership from 10% to 6.25% easily satisfies § 302(b)(2) for exchange treatment). Although not all commentators agree that the effect of a dividend under § 356(a)(2) is a matter that must be judged under § 302 principles, *see* Rands, *Section 356(a)(2): A Study of Uncertainty in Corporate Taxation,* 38 U. MIAMI L. REV. 75, 106-16 (1983), the text proceeds under the assumption that the tools of § 302 are to be used. Not only do the courts adopt this strategy, as Professor Rands concedes, *see id.* at 106, but it is also difficult to see what other strategy would be appropriate. It is *not* disturbing that when using § 302 principles here, a distributee who retains greater continuity of interest is more likely to suffer dividend income treatment, *see id.* at 104-05, for this is a familiar pattern in subchapter C: the more a shareholder exits the corporation, the more exchange treatment is likely.

could, even in a world with no preferential rates for such gain, be offset by capital losses and would carry over a basis of $10 in the *Z* stock she receives. *G*'s ownership share, on the other hand, actually increased in this last transaction so that the $7 distribution to her would be ordinary dividend income.[95] *G* would also keep a basis of $10 in her new *Z* shares.

> (q) Reverse the order of the events described in recharacterization (p) and view the distributions as occurring postreorganization.

Had there been no distribution, the reorganized enterprise would have contained $300 in assets, and *F* and *G* would each have held 50/300 of the shares of an enlarged *Z*. Assuming that neither *F* nor *G* previously owned stock in *Z*, a $15 distribution to each shareholder would drop each ownership share from 50/300 to 35/270, or from 16.7% to 13%. Since exchange treatment under section 302(b)(2) requires only a 20% drop from 16.7% to below 13.3%, *F* and *G* succeed in avoiding dividend treatment. Each has a gain of $15 to report, but it is not ordinary dividend income.

This postreorganization characterization does not always yield the taxpayers favorable treatment. For example, had only $13 or less been distributed by *Z* to each former shareholder of *Y*, this recharacterization would not have included a sufficiently non-pro rata redemption to earn favorable treatment. Nevertheless, it is clear why taxpayers generally prefer (q) to (p).[96] The presence of additional shareholders in the postreorganization enterprise causes distributions to shareholders who were part of one prereorganization company to appear more non-pro rata when viewed post- rather than prereorganization.[97]

> (r) Compare a distributee's ownership share prereorganiza-

Put in terms of broader capital gains arguments, when more cash is received in one time period, a telescoping argument suggests preferential treatment.

[95] Moreover, *G*'s ownership share would exceed 50%. *See* I.R.C. § 302(b)(2)(B) (1982); *infra* note 110.

[96] *See infra* notes 97, 108.

[97] This assumes that acquisitive reorganizations are more common than divisive ones. In a § 355 *exchange* that is part of a divisive reorganization, there are often fewer taxpayers in a postdivision enterprise. Accordingly, a taxpayer who receives boot is likely to wish for recharacterization (p) to be the accepted approach because (p) is a prereorganization perspective that will more often make the distribution to the taxpayer appear more non-pro rata. *See* B. BITTKER & J. EUSTICE, *supra* note 1, ¶ 13.11 (noting that the automatic dividend treatment of § 356(b) is limited to § 355 *distributions* (spin-offs) as opposed to exchanges and that exchanges are evaluated by the criteria of § 356(a)(2)). The Commissioner has, in fact, consistently selected approach (p)'s prereorganization perspective in divisions. *See, e.g.,* Rev. Rul. 74-516, 1974-2 C.B. 121, 122 (distribution to shareholder in split-off transaction treated as capital gain). Profes-

tion with the share held by that stockholder postreorganization and postdistribution.

Suppose, for example, that *G* receives $5 in cash and $45 of *Z* stock, thus failing to qualify for exchange treatment under either (p) or (q). *G*'s ownership share can be viewed as dropping from one-half at the outset to 45/270, or 16.7%, at the completion of the recharacterization, easily meeting the safe harbor of section 302(b)(2). *F,* who receives $25 in cash and $5 in *Z* stock, starts out as a 50% owner and emerges with 25/270, or 9.3%, so that she too easily qualifies for exchange treatment. This before-and-after comparison, which might be labeled a "pre with post" recharacterization, seems attractive because, like section 302(b) itself, it focuses on the change in each distributee's voting power. In the illustration just encountered, for instance, *F* and *G* may deserve exchange rather than ordinary dividend treatment because they have relinquished their power to veto corporate decisions. Approach (r), however, does not seem quite complete. If the distribution to either *G* or *F* takes place before the *Y-Z* merger, then section 302(b) requires a calculation of the sort done in (p). If the recharacterization instead involves a later, postreorganization distribution, then recharacterization (q) follows the letter of section 302 and contains the appropriate calculation.

If recharacterization (r) were adopted in judicial decisions, it would be easy to say that it reflects the spirit of section 302(b), but, inasmuch as (r) has been tried and has failed,[98] it seems useful as a positive matter to highlight its incompleteness.[99] There is also a technical objection to the approach in (r): when section 356(a)(2) speaks of

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sor Fleming, on the other hand, has suggested that the taxpayer can argue that distributions should always be viewed as coming out of the *combination* of two entities. Thus, even if one chooses a postreorganization recharacterization, or (q) view, for acquisitive reorganizations, one could choose a prereorganization perspective in the case of divisions. *See* Fleming, *Reforming the Tax Treatment of Reorganization Boot,* 10 J. CORP. TAX'N 99, 112-13 (1983).

[98] *See infra* note 107 and accompanying text.

[99] One commentator has captured the essence of completeness by criticizing (r) because "[i]t is of no value to attempt to apply section 302(b)(2) to . . . [the percentage of ownership] before and . . . after because the two numbers are simply not comparable." Kyser, *The Long and Winding Road: Characterization of Boot Under Section 356(a)(2),* 39 TAX L. REV. 297, 299 (1984). Indeed, recharacterization (r)'s attempt to dissociate the question of changing control from the nature of a distribution may be a bit too much like taxpayer attempts to unlink cash from proximate B-reorganizations, which are normally thought to fail when consideration other than voting stock is used.

Any success that (r) might have in the future would presumably reflect a judgment about the nature of § 302(b)(2) and would not contradict any of the recharacterization rules advanced in this Article.

the "earnings and profits of the corporation,"[100] the word *the* may mean that only one corporation is involved. Recharacterization (r), unlike (p) and (q), requires that the distributee's relationship with *two* corporations, the "pre with post" transaction corporations, be contemplated.

> (s) If the taxpayers can see that the distribution is not large enough to make (q) useful to them, as when *F* and *G* are to receive and share evenly $26 of cash and $74 in *Z* stock, then they might time the distributions in a way that is consistent with claiming that only one shareholder was redeemed before, and the other after, the reorganization.[101]

Suppose, for example, that shareholder *G* has capital losses to use and *F* does not. Their recharacterization could then incorporate an earlier redemption for *F*, and a later redemption for *G*. *F*'s ownership share will drop from 50/100 (50%) to 37/87 (42%) and will fail to qualify for exchange treatment because this drop to 42% is insufficient under section 302(b)(2). Postreorganization, however, *G* receives $13 and drops from a 50/287 (17.4%) to a 37/274 (13.5%) shareholder, which does qualify for exchange treatment.[102] *G*'s gain will be capital rather than ordinary, and, under section 1211, the gain may be offset by capital losses.[103]

Although recharacterization (s) is complete and direct, this "pre then post" recharacterization probably deserves to be rejected on both positive and, dare it be said, normative grounds. *Whenever* shareholders receive pro rata dividends, an imaginative taxpayer could claim that selected shareholders were redeemed and then, after some time had passed, that others were redeemed in a separate transaction. If tax law requires that paper records be consistent with claims, it should not be difficult to convince corporations and other shareholders to cooperate and take turns at winning the prize.[104] Section 302(b)(2)(D) addresses this notion by emphatically denying exchange treatment when the "effect" is of a "series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the

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[100] I.R.C. § 356(a)(2) (1982).

[101] *See supra* notes 45 & 77.

[102] Section 302(b)(2) requires a drop below 80% of the former ownership share, in this case from 17.4% to below 13.9%.

[103] I.R.C. §1211 (1982 & West Supp. 1987).

[104] Again, the discussion in the text assumes that taxpayer actions and filings must support, rather than contradict, later recharacterizations, although this is not always the case.

shareholder."[105] *G* might claim that, even in the aggregate, the redemption is disproportionate with respect to other shareholders of *Z*, but the spirit of section 302(b)(2)(D) defeats this argument.[106] There is no reason why *F* and *G* would have agreed to the timing and ordering of the redemptions in recharacterization (s), other than as an attempt to escape the tax treatment that is specifically contemplated in section 302(b)(2)(D).

The approaches in (r) and (s) have little chance of emerging in tax law. While recharacterization (s) has not been explicitly rejected by a court, in part because no taxpayer has proposed such treatment, (r) was rejected by the Fifth Circuit after its temporary adoption by two district courts.[107] In contrast, approaches (p) and (q), encouraged by the Commissioner and taxpayers respectively, have had some continuing success in the courts, with (q) enjoying a real edge, but neither has emerged as dominant.[108]

There are five potentially useful arguments for assessing the relative worth of recharacterizations (p) and (q). First, two technical argu-

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[105] I.R.C. § 302(b)(2)(D) (1982).

[106] *See* B. BITTKER & J. EUSTICE, *supra* note 1, ¶ 9.04 (illustrating the use of § 302(b)(2)(D) as a weapon against attempts to abuse § 302(b)(2)).

[107] *See* Sellers v. United States, 615 F.2d 1066, 1068 (5th Cir. 1980) (rejecting lower court finding that cash boot was the equivalent of a dividend distribution), *aff'g in part & rev'g in part* 42 A.F.T.R.2d (P-H) §§ 78-6195, 78-6197 (N.D. Ala. 1977); General Housewares Corp. v. United States, 615 F.2d 1056, 1066 (5th Cir. 1980) (noting that, after Shimberg v. United States, cash distributions in a prereorganizational context are to be treated as dividend distributions), *rev'g* 488 F. Supp. 926, 937-38 (N.D. Ala. 1977); Shimberg v. United States, 577 F.2d 283, 290 (5th Cir. 1978) (reasoning that if prereorganization distribution would be a dividend, merger should make no difference), *rev'g* 415 F. Supp. 832, 836 (1976), *cert. denied,* 439 U.S. 1115 (1979). Unfortunately, these reversals were not accompanied by either clear explanations or by the § 302(b)(2)(D) argument sketched above.

[108] *Compare* Wright v. United States, 482 F.2d 600, 608-09 (8th Cir. 1973) (agreeing with (q)'s protaxpayer view and going even further by appealing to § 302(b)(1) rather than § 302(b)(2)(B)) *and* Clark v. Commissioner, 828 F.2d 221, 224-28 (4th Cir. 1987) (affirming tax court opinion that had agreed with the *Wright* test and arguing that the redemption notion presupposes a surviving enterprise, but basing the decision on the "net effect" of both steps) *with Shimberg,* 577 F.2d at 288 (5th Cir. 1978) (pro-Commissioner, (p) approach). A preference for one approach over the other has not emerged in the tax literature. For citations to commentators favoring (p) or (q), but doing so before the *Clark* decision, see Kyser, *supra* note 99, at 299 nn.14-15. *Clark,* a decision that toys with using the idea of the order within *Zenz,* surely gives the edge to (q) over (p). Unfortunately, the *Clark* decision focuses on the "net effect" of the transactions in *Zenz* and *Clark. See Clark,* 828 F.2d at 228. "Net effect," however, cannot be a useful test in corporate tax. It may at first seem appropriate to note that Mr. Clark surrendered a greater than 20% interest in the enterprise he was joining because he could have taken more stock and less cash than he actually received. However, when one considers the taxpayer who receives a cash dividend and then reinvests it in the distributing corporation, it becomes clear that "net effect" is not a powerful test because the taxpayer surely has dividend income to report even though the "net effect" of the two transactions is that the taxpayer has received no cash.

ments can be made. Section 356(a)(1)(B) purports to address a situation in which "the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money."[109] This provision suggests that the permissible property, which was *Z* stock in the earlier example, and the money come from the same place. If so, the "post" view in recharacterization (q) fits the statute better than (p)'s "pre" view, because the *Z* stock obviously comes from *Z*.

Second, the inquiry called for in section 302(b) seems most natural when there is a surviving entity in which the distributee's ownership share can be evaluated. If, for example, a redemption causes the distributee to drop from a 90% to a 55% ownership share, the distribution will normally be found to have the effect of a dividend because section 302(b)(2)(B) gives no effect to a large drop in ownership when the distributee retains a majority interest.[110] It is not surprising to see such a requirement present in a normal or postreorganization setting, because a majority shareholder eager to receive exchange rather than dividend treatment may not care what percentage of the stock she owns so long as her continuing control is ensured. In constrast, it is more difficult to comprehend the point of this subsection if the "pre" approach is correct, for control lasts but a moment before the reorganization erases its power.[111]

A third argument favoring recharacterization (q) initiates the final recharacterization rule of this Article, consistency. The essence of the rule of consistency is that the order of events within a recharacterization *should* be, as a normative matter, or *might* be, as a positive matter, consistent with the order adopted in other recharacterizations in "related" controversies or areas of law.[112] Approach (q) first entails a change in ownership of a corporation, and then it *ends* with a corporate contraction. The Commissioner generally prefers approach (p), however, which *begins* with a corporate contraction, since it describes the distribution of cash as occurring prereorganization. But the Commissioner lost in—and eventually acquiesced to—*Zenz v. Quinlivan*,[113]

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[109] I.R.C. § 356(a)(1)(B) (1982).

[110] I.R.C. § 302 (b)(2)(B) (1982) (disallowing exchange treatment unless "immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote").

[111] This argument is found in Wright v. United States, 482 F.2d 600, 607 (8th Cir. 1973).

[112] This quality was discussed earlier. *See supra* text accompanying notes 5-7. Reasonable people can, of course, disagree over which controversies are "related." *See infra* note 133 and accompanying text.

[113] 213 F.2d at 916.

in which the distribution of cash occurred *after* a sale of shares brought in a new shareholder.[114] Approach (q) is thus more like *Zenz* than is (p), and the decision in *Zenz,* involving a late distribution, might be of precedential value to (q).

It is useful to restate this potential link between bootstrap acquisitions and distributions which occur in the context of reorganizations, first in a purely positive tone and then in practical terms. If *Zenz,* or recharacterization (k), remains good law *and* recharacterization (q) emerges as the preferred interpretation of section 356(a)(2), consistency would be a promising recharacterization rule because, in both (k) and (q), distributions are inserted earlier rather than later in time. Put in terms of the practice of tax law rather than in terms of positive legal theory, *Zenz* may be of precedential value for a taxpayer who wishes to argue for the exchange treatment associated with the approach in (q). When the argument is expressed in such precedential language, however, it becomes apparent that the content of the seemingly innocuous tool of consistency may depend on the very broad and often political question of the scope and power of precedent.[115] Like the relevance of a precedent, the application of consistency is a subjective question. In the small matter at hand, for example, a reasonable person might argue that consistency is a powerful positive or normative goal but that the *Zenz*-like ordering of a redemption around a sale of stock is simply a different question from the ordering of a redemption around a reorganization, as in recharacterizations (p) or (q). Although this Article does not confront the problem of the coherent meaning of precedent,[116] it is nevertheless noteworthy that *Zenz* and approach (q) are more easily seen as consistent than are *Zenz* and recharacterization (p).

Although all three of the preceding arguments favor approach (q), approach (p) is not indefensible. From a technical perspective, it can be argued that (p) best agrees with "the corporation" language in section 356(a)(2).[117] Viewed from the vantage point of recharacterization (p), the statute tells taxpayers like *F* and *G* that those receiving money from *Y* will qualify for exchange treatment if *Y* does not have sufficient earn-

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[114] *See supra* notes 76-77 and accompanying text.

[115] *See* Deutsch, *supra* note 61, at 1583-84; Lyons, *Formal Justice and Judicial Precedent,* 38 VAND. L. REV. 495, 505-10 (1985); Schauer, *Precedent,* 39 STAN. L. REV. 571, 602-05 (1987).

[116] As an abstract matter, precedent seems to be both a matter of context, *see* Deutsch, *supra* note 61, at 1584, and of shared culture. As an operational matter, however, one can study decisions and develop views of how broadly, narrowly, or incoherently precedents are construed. In turn, one can test one's views about the meaning of precedent by trying to predict the outcomes of future decisions.

[117] *See supra* text accompanying note 100.

ings and profits. This treatment corresponds to the standard mechanics of dividend distributions found in sections 301(c)(1) and 316.[118] In contrast, approach (q) complicates the message in section 356(a)(2) by requiring one first to imagine a pure stock-for-stock reorganization in which *Z* takes on *Y*'s earnings and profits account and then to calculate *F* and *G*'s ratable shares of this newly enlarged account. This is not impossible, but, at the very least, it is sufficiently inelegant that one wonders whether such an approach is what the drafters of section 356(a)(2) had contemplated. Furthermore, the extra step required in recharacterization (q) to calculate the ratable share of earnings and profits violates the brevity rule, although in a way that is not quite the same as earlier examples.[119] Approach (q) also appears to be indirect because *Z* first increases in size from $200 to $300, and then, by paying out $30, it subsequently shrinks to $270. In contrast, recharacterization (p) involves no such backtracking because it simply allows *Z* to grow from $200 to $270.

Such a claim regarding (q)'s indirectness, however, is inherently weak. In approach (p), while it is true that *Z* does not backtrack, *Y* shrinks from $100 to $70 in size and then grows into a part of a $270 organization. This is just as indirect as *Z*'s growing and then shrinking in approach (q). If there is a difference between the two maneuvers, it derives from the assumption that when two entities are combined, it is the larger entity that is the acquiror, and it is only this larger entity that should be described in a way that avoids backtracking. In reality, however, some target corporations shed divisions before being acquired, while some acquiring corporations shed divisions of targets they have acquired. The choice between such early and late shrinkages is often motivated by nontax considerations. Consequently, it is reasonable not to regard (q) as any less direct than (p).[120] On the other hand, in its

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[118] *See supra* notes 36-37 and accompanying text.

[119] *See supra* text accompanying note 82.

[120] Approach (q) might be regarded as more indirect because, although there are good reasons for an acquiror, rather than a prereorganization target, to sell off parts of a company it has purchased (indeed, its comparative advantage may be that it knows how to divide up an entity and sell some divisions to buyers who can more efficiently employ their assets or workers), it is hard to think of a nontax reason why the acquiror would be better at distributing cash. This last argument against (q) still requires as a starting point, however, the notion that the larger company's progress should be even, while the smaller one can backtrack. In practice, it is far from clear that either an acquiror or a target would always have the comparative advantage in locating purchasers for assets that are sold in the shadow of a reorganization. It is therefore fair to label (q) as barely, if at all, indirect.

Although it may be tempting to look to the rules regarding the "pruning" of unwanted assets before a reorganization as a source of inspiration for the (p) versus (q) controversy because cash can be thought of as an unwanted asset, this perspective is rules governing the carryover of losses, the Code does insist on a distinction, albeit manipulable, between acquirors and targets: losses in a post-merger entity may generally be carried back for three years to offset profits of the acquiror, but not those of the target, earned before the merger.[121] As a positive matter, therefore, there may be validity to the claim that (q) is indirect.

In summary, while these five arguments do not point to the clear superiority of (p) or (q), it can be argued that (q) has an edge. In purely positive terms, the rejection of approach (r) can be understood as reflecting its incompleteness, and the implicit rejection of (s) relates to that recharacterization's contradiction of the spirit of section 302(b)(2)(D). As for (p) and (q), one can regard the still ongoing competition between them as a consequence of the statutory and other arguments on both sides. On the other hand, the combination of *Zenz* and (q)'s recent judicial success[122] can be taken as illustrative of the predictive utility of the consistency rule.

D. *Consistency in Determining Ownership Shares*

One last example brings the consistency idea into clearer focus. When a corporation is liquidated, there is normally both a corporate-level tax due under new section 336 on all the previously unrecognized gain in those assets held by the corporation and a shareholder-level tax due under section 331 on the difference between the value of the liquidating distributions received by each shareholder and the basis in the shareholder's stock.[123] In the case of a parent-subsidiary or intercorpo-

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unproductive because the relevant decisions involve pruning by *both* acquiring and acquired corporations. *See* B. BITTKER & J. EUSTICE, *supra* note 1, ¶ 14.52.

[121] I.R.C. § 381(b)(3) (1982) disallows the carryback of postmerger losses to the profitable history of the target and, by implication, allows such carrybacks to the enterprise's *own* premerger history. This asymmetry stands in contrast to the carry-forward rules of § 382, which leave selected losses breathing in a way that does not depend on the identification of one enterprise as the acquiror and the other as the target. *See* I.R.C. §§ 382(g), (k) (West Supp. 1987) (providing that the change of ownership triggering the carryover limitations in the provision can involve either the acquiror or the target corporation). The ability to carry back losses is generally more limited than the ability to carry forward such losses. *See* I.R.C. § 172 (1982) (allowing net losses to be carried forward 15 years but back only 3).

[122] *See* Clark v. Commissioner, 828 F.2d 221, 228 (4th Cir. 1987).

[123] If a corporation sells all its assets and then liquidates, there is a two-level tax. The first is levied as a matter of course when the assets are sold. The repeal of former § 337, which once forgave this tax, ensures that there is a tax on the sale of assets. *See* I.R.C. § 336(a) (1982 & West Supp. 1987). The shareholder-level tax on the difference between the liquidating distributions and the basis each shareholder has in her stock is due under § 331. *See* I.R.C. § 331(a) (1982). Some small corporations will continue to enjoy one-tax treatment upon liquidation under former sections 336 and 337. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 633, 100 Stat. 2085, 2278,

rate liquidation, however, these taxes are not collected under the terms of section 332, which addresses a corporate distributee or parent that owns more than 80% of the liquidating corporation,[124] and new section 337(a), which deals with the liquidating subsidiary on its distributions to its 80% parent.[125] The rationale behind these last two rules is that since appreciated assets remain in corporate form in the distributee's, or parent's, hands, there is no need to levy taxes at the time a parent liquidates its subsidiary; instead, when these assets leave the parent's hands, tax will be collected.[126] Section 334(b)(1) thus appropriately provides that in such a "332 liquidation," the parent-distributee inherits the asset basis held by the subsidiary.[127] In short, a liquidation normally triggers a two-level tax and generates a step-up in asset basis, but an 80% parent can liquidate its subsidiary without triggering any taxes, deferring the tax by carrying over the bases of assets.

What if a parent that owns only 79% of a subsidiary's stock wishes to liquidate the subsidiary, but defer taxation? If this parent does not wish to acquire additional shares and then wait a long time before liquidating the subsidiary, it might try to "back in" rather painlessly to section 332. In order to satisfy the 80% hurdle, the parent corporation will pause for a moment before the liquidation and either purchase some shares from the 21% minority shareholders or cause the subsidiary corporation to redeem a few shares from its minority owners. The Commissioner has objected to this maneuver and has insisted that the relevant ownership share is that which was in place at the time the liquidation plan was adopted and before a redemption was engineered.[128] The Commissioner's objection to what normatively might

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(1986).

[124] *See* I.R.C. § 332(b) (1982 & West Supp. 1987).

[125] *See* I.R.C. § 337(a) (1982 & West Supp. 1987) ("No gain or loss shall be recognized to the liquidating corporation on the distribution to the 80-percent distributee of any property in a complete liquidation to which section 332 applies."). Gain, but not loss, is recognized to the liquidating corporation on distributions to any minority shareholders. *See* I.R.C. § 336(d)(3) (1982 & West Supp. 1987).

[126] The parent will be taxed under current § 336 and the ultimate shareholder will be taxed under § 331. The latter is entitled to exchange, rather than dividend, treatment. *See* I.R.C. §§ 336(a) (1982 & West Supp. 1987); I.R.C. § 331(a) (1982); *infra* note 153 and accompanying text.

[127] *See* I.R.C. § 334(b)(1) (1982).

[128] *See* Rev. Rul. 70-106, 1970-1 C.B. 70, 70-71 (holding the nonrecognition exception inapplicable when the subsidiary redeemed the required shares after the parent's informal adoption of a liquidation plan, even though formal adoption of the plan occurred after the share redemption). *But see* Rev. Rul. 75-521 1975-2 C.B. 120, 120-21 (distinguishing Rev. Rul. 70-106 and allowing nonrecognition when the parent waits until after purchasing the requisite shares to adopt a liquidation plan). The adoption of a liquidation plan may be effected formally or informally, as Revenue Ruling 70-106 implies, but "the formation of a conditional general intention to liquidate in

seem like a harmless scheme is interesting because the backing-in plan is inconsistent with *Zenz*![129] *Zenz,* once again, described the redemption or contraction of the corporation as occurring late in a recharacterization, during the last step in the sole stockholder's complete transfer of her business.[130] In contrast, backing into section 332's 80% ownership condition requires the taxpayer to describe the contraction as occurring early, before the liquidation.[131]

The predictive utility of the consistency rule is especially enhanced in this context by the fact that courts have permitted taxpayers to "back *out*" of section 332 and into the normal two-level tax and stepped-up basis liquidation rules associated with section 331.[132] If an 80% parent, wishing perhaps to recognize losses upon the liquidation of its subsidiary, seeks to drop below 80% and escape section 332's nonrecognition rules, it can either sell a few shares just before liquidating or it can cause the subsidiary to issue some new shares to unrelated shareholders. Neither alternative is inconsistent with *Zenz.* These alternatives are either best regarded as much like *Zenz,* in that both involve early stock sales, or as simply not comparable to *Zenz,* because backing-out involves no contraction at all.[133] In short, the decision to permit backing

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the future is not the adoption of a plan of liquidation." George L. Riggs, Inc. v. Commissioner, 64 T.C. 474, 488 (1975).

[129] *See Zenz,* 213 F.2d at 916-18; *supra* note 77 and accompanying text (discussing the formalistic effect of *Zenz*); *supra* text accompanying notes 113-16 (discussing the post-*Zenz* context). Note that the Commissioner does not always adopt positions that maximize the government's revenues.

[130] *See* 213 F.2d at 916. *See also* approach (k) at *supra* text following note 61, modeling *Zenz.*

[131] To meet the 80% requirement of § 332, the parent must cause the subsidiary to repurchase some minority owners' shares, if this is the backing-in method chosen, *before* liquidation. *See supra* note 128.

[132] *See, e.g.,* Granite Trust Co. v. United States, 238 F.2d 670, 674 (1st Cir. 1956) (permitting backing-out in order to recognize loss under predecessor of § 331). Note that it is not the 80% requirement itself that is the subject of this consistency inquiry, for that is a dividing line used frequently in the Code, but rather it is the question of whether taxpayers can back into or out of this requirement.

[133] In assessing consistency or precedent, if one's aesthetic sense suggests that *Zenz* and backing-out concern similar circumstances, then the fact that the taxpayer's success in *Zenz* hinged on an early stock sale followed by a complete redemption of the seller's remaining shares may seem important in precedential terms for policing § 332's ownership requirement. Inasmuch as backing-out can also turn on an early stock sale, it appears quite consistent with or even supported by *Zenz.* On the other hand, much as precedential value is often linked to the relevant domain of the earlier decision, here one could simply shrug and say that *Zenz* involves a bootstrap acquisition with a mere *contraction* by the corporation, while the § 332 backing-out question involves a liquidation. Thus, apples and oranges need not be governed by the same rules.

Were it not for this last argument, it would also seem that backing into § 332 should fail via redemption because *Zenz* incorporates a later, rather than an earlier-in-time contraction, but that backing-in need not necessarily fail if accomplished through the purchase of stock. In the latter case, it is arguable either that *Zenz* also calls for an out of section 332, the decision in *Zenz,* and the Commissioner's objection to backing into section 332, taken together, are fair evidence that the consistency rule is a useful descriptive tool.[134]

III. Normative Aspects of the Hidden Rules of Recharacterizations

The discussion in Part II presented a systematic approach to assessing the acceptability of recharacterizations of corporate transactions. This positive theory is "retrospectively descriptive" in that it reveals the rule structure of past decisions in a way that is, perhaps, convincing and elegant. The framework is also predictive in that it provides four rules that may foretell the outcomes of future cases.[135] Every reader of legal scholarship is familiar with such retrospectively descriptive and predictive theories. For example, one such theory suggests that the development of negligence, as opposed to strict liability, in the law of torts paralleled the growth of manufacturing in our country.[136] Other de-

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early stock purchase or that the backing-in maneuver simply involves no contraction and is not comparable to *Zenz.* This line of reasoning should not be troubling simply because it suggests different treatments depending on the style of backing-in. Because redemptions are a subset of stock purchases, the most useful way to think about consistency with respect to *Zenz* seems to hinge on the contraction aspect of bootstrap acquisitions. When backing-in can be accomplished without a corporate contraction, *Zenz* is arguably irrelevant.

[134] Readers familiar with the evolution of corporate tax law might also wish to check on the consistency of backing into former § 338(c)(2) and even former § 334(b). *See* Madison Square Garden Corp. v. Commissioner, 500 F.2d 611, 612-14 (2d Cir. 1974) (allowing backing-in via redemption rather than purchase under § 334(b) of the 1954 Code). *See also* Ginsburg, *Taxing Corporate Acquisitions,* 38 Tax L. Rev. 177, 293-95 (1983) (noting that the position taken by the IRS in Rev. Rul. 70-106 created problems under § 338 when the purchased corporation was not liquidated but was backed into by the purchasing parent).

In these older contexts, the most important determinant was probably not consistency, but a sense that unlucky or badly advised taxpayers should not lose out. The tax law intended to provide a route to a one-tax result, and backing-in ensured the availability of that route to the taxpayer who mistakenly redeemed before liquidating.

[135] In the taxonomy of positive law theories there are also descriptive theories that address the future but that are not at all predictive as to individual cases. Theories based on the psychological profile of the decisionmaker or on the notion that in some areas of law decisionmaking is a random process are two such examples. These kind of theories are not addressed in the remainder of this Article for two reasons. First, the intersection of positive and normative theories can be argued without reference to this last sort of positive theory. Second, such theories are few in number, and especially rare in corporate tax law.

[136] *See* L. Friedman, A History of American Law 467-69 (2d ed. 1985) ("Absolute liability was rejected; more accurately, it was never considered. In the mind of the 19th century, absolute liability might have been too dangerous; it might have strangled the economy altogether."); M. Horwitz, The Transformation of American Law: 1780 to 1860, at 99 (1977) (noting that the negligence standard supplanted strict liability first in states having advanced economic development). *But see*

scriptive theories assert that damage rules in contract law encourage efficient but not inefficient breaches[137] and that restitution claims are allowed only when recipients benefit unambiguously from the goods or services rendered.[138] Theories that link exclusions under warranties to moral hazard problems[139] or that associate penalties for nonrescue with countervailing rewards for rescue[140] are predictive as well as descriptive. These last two theories, concerning warranty and rescue, identify structural reasons for the existence of certain rules,[141] and because these reasons will persist, the theories predict, at least implicitly, that results in the future will be much like those in the past. In contrast, the first three descriptive theories listed above—pertaining to negligence, contract damage, and restitution—do not, standing alone, make predictive claims about the outcomes of future cases.[142]

While many other positive applications of the tools introduced in

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Schwartz, *Tort Law and the Economy in Nineteenth-Century America: A Reinterpretation,* 90 YALE L.J. 1717, 1727-34 (1981) (arguing not only that Horwitz errs in stating that strict liability had been the established standard of all American torts, but also that the negligence standard and tort law as a coherent body developed simultaneously).

[137] *See* R. POSNER, ECONOMIC ANALYSIS OF LAW 105-14 (3rd ed. 1986) ("The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,—and nothing else." (quoting Holmes, *The Path of the Law,* 10 HARV. L. REV. 457, 462 (1897))); Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach,* 77 COLUM. L. REV. 554, 558-59 (1977) (noting that the breacher's retention of net gains from the breach provides an incentive for efficient breach).

Although the efficient breach theory is not always articulated in descriptive terms, it forms a powerful descriptive theory of why expectancy damages (and not more) have emerged in American law and why specific performance continues to be used only in certain circumstances or in other legal systems. *See* Bishop, *The Choice of Remedy for Breach of Contract,* 14 J. LEGAL STUD. 299, 304 (1985) (presenting the choice of remedy as dependent on a time continuum: "it will be efficient to switch from damages to specific performance depending on how complete performance is").

[138] *See generally* Levmore, *Explaining Restitution,* 71 VA. L. REV. 65 (1985) (exploring restitution law's sensitivity to the recipient's valuation of benefits).

[139] *See* Priest, *A Theory of the Consumer Product Warranty,* 90 YALE L.J. 1297, 1313-14 & n.98 (1981).

[140] *See generally* Landes & Posner, *Salvors, Finders, Good Samaritans, and Other Rescuers: An Economic Study of Law and Altruism,* 7 J. LEGAL STUD. 83, 85-100, 128 (1978) (comparing the predictions of an economic model of rescue to assessments of actual legal outcomes and concluding that economic analysis provides the basis of a valid positive theory); Levmore, *Waiting for Rescue: An Essay on the Evolution and Incentive Structure of the Law of Affirmative Obligations,* 72 VA. L. REV. 879, 891-94 (1986) (exploring the different balances of "carrots" and "sticks" available to influence behavior).

[141] Costs are an example of such a structural reason. *See Priest, supra* note 139, at 1351-52. Moral hazards are another such reason. *Id.* at 1313-14.

[142] The efficient breach theory can be transformed into a predictive theory with a claim about the evolutionary efficiency of the common law of contracts, under which parties can generally bargain around unattractive rules.

Parts I and II remain to be explored, enough material has been presented in this Article to turn attention from the practical and predictive utility of these tools to their normative value. Whether a descriptive or predictive theory[143] *should* be utilized by judges resolving disputes is an interesting and elusive question. This Article argues that corporate tax law poses a special case for the consideration of the intersection of positive and normative concerns and that in determining the acceptability of recharacterizations, judges should follow the four rules developed in Part II.

Positive theories and normative values are sometimes fairly separable.[144] This is especially, or even uniquely, true in corporate tax law where rules and decisions are almost necessarily devoid of a normative foundation and are especially arbitrary. Corporate tax law is arbitrary because, like most of American tax law, it requires a specific recognition event before it taxes appreciation in asset values[145] and because it regards corporations as taxable entities that are distinct from their

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[143] If a predictive theory is adopted as a guide for decisionmakers, it will, of course, become a self-fulfilling theory.

[144] A positive theory may be quite convincing even though it is normatively indifferent or unappealing. *See generally* H.L.A. HART, *Positivism and the Separation of Law and Morals,* in ESSAYS IN JURISPRUDENCE AND PHILOSOPHY 49 (1983) (discussing the separation of the "positive" law and its normative elements). Thus, a positive theorist may suggest that the poorer party generally loses or wins in a particular area of law, *see, e.g.,* Galanter, *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change,* 9 LAW & SOC'Y REV. 95, 103-104 (1974) (noting that the "position of advantage [enjoyed by repeat players in the legal system] is one of the ways in which a legal system formally neutral as between 'haves' and 'have nots' may perpetuate and augment the advantages of the former."), while normatively believing that the poorer party should win, or while contemplating that decisions should be based on some other factor that is not correlated with wealth or poverty, or without having a normative valuation of the issue at all. Conversely, normative theories can stand almost entirely apart from positive theories. There may be many strong reasons directing what the law or a judge *should* do in a given circumstance, even though it is quite clear that these ideas have little to do with how existing law has developed and may, indeed, have no effect on future law. *See* H.L.A. HART, *supra,* at 54 (noting Bentham's and Austin's assertions that morality can neither descriptively nor predictively determine what law is). Thus, a normative theorist might argue that when no "better" decisionmaking variable is available, the poorer party should win, or the law should decide the dispute in some way that can and should be imitated later on because certainty and predictability are normatively desirable. These normative arguments do not necessarily lose force if it is clear that prior law does not follow these suggestions. This discussion later returns to the "separability" of positive and normative concerns. *See infra* note 158 and accompanying text.

[145] In the opinion of most economists, the realization requirement implicit in the Code results in a less accurate measurement of income than an accretion approach would generate. *See* B. BITTKER, 1 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶¶ 3.1.1, 3.5.2 (1981) (discussing the Haig-Simons accretion approach and its use as a standard for judging the merits of a statutory definition of income). The reduced accuracy has customarily been justified by increased administrability. *See id.* ¶ 5.2.

shareholders.[146] These features are best labeled arbitrary, rather than unfair or inefficient,[147] because it is not entirely clear that alternative rules would be any more efficient or fair.[148] The point is not to "defend" the fundamental rules of the tax system as merely arbitrary, but rather to note that because these rules are arbitrary, it is virtually impossible to develop normative arguments about questions that arise as a result or in the shadow of these basic starting points. The nature of corporate tax law often defies normative argumentation.

Consider, for example, the last set of problems discussed in Part II, concerning the ability of corporate taxpayers to "back into" or to "back out of" degrees of ownership specified in the corporate tax statutory sections. When a parent corporation owning 79% of a subsidiary tries to back into section 332, which governs the treatment of a parent liquidating its 80%-owned subsidiary, by purchasing some additional shares of the subsidiary just before its liquidation,[149] it is virtually impossible to articulate relevant normative arguments. It is not normatively evident or, more colloquially, it is not clear from a policy standpoint, why these rules should require a parent to recognize or to defer gain when liquidating a subsidiary. Indeed, there are in general no externally-based reasons to recognize gains at the particular moments chosen by the Code or, for that matter, to defer gains only when a parent owns at least 80% of a subsidiary. Deferral and recognition are not neutral concepts in policy terms. One might, on the margin, prefer deferral rules because recognition rules discourage those things that will be counted as recognition events,[150] but to permit deferrals is eventually either to forgive, which has its own efficiency costs,[151] or to recognize gains built up over a longer period, which is then a treatment

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[146] To say that the taxation of corporations as legal entities is arbitrary is not to suggest that such taxation is necessarily inconsistent with other aspects of corporate law. The legal personality of the corporation is, of course, one of its practical advantages. *See* N. LATTIN, THE LAW OF CORPORATIONS § 11 (2d ed. 1971).

On economic grounds, the separate taxation of corporations has often been criticized. *See* B. BITTKER, *supra* note 145, ¶ 3.5.6 ("Most economists . . . regard the corporate income tax as an anomaly.").

[147] *See* J. PECHMAN, FEDERAL TAX POLICY 135-36 (3d ed. 1977) (noting that the corporate income tax has continually been criticized because of its effects "on investment and saving, equity and debt finance, resource allocation, the built-in flexibility of the tax system, and the balance of payments").

[148] *See* Levmore, *supra* note 56, at 496-502.

[149] *See supra* notes 123-134 and accompanying text.

[150] A rule calling for appreciation to be taxed at the time an asset is sold or exchanged, for example, tends to encourage the owner to retain possession of the asset even though, taxes aside, she prefers a sale or exchange. *See* Levmore, *supra* note 56, at 486.

[151] It can also be inefficient to encourage taxpayers to hold on to assets and await low-tax years or death and a tax-free step-up.

most profitably avoided.[152]

There is, in short, no normative theory or rule that suggests the optimal number or coverage of recognition rules. Given the decision to tax corporate gain and the decision to await recognition events, rather than to call for and tax periodic appraisals of changes in net worth, it is hard to argue passionately for or against a particular trigger, or recognition event. Similarly, it is difficult to have strong feelings about the wisdom of an 80% divide. On the one hand, a rationale behind section 332 is that as long as assets remain in corporate solution deferral does not generate rate-shopping.[153] On the other hand, allowing all intercorporate asset transfers to be nonrecognition events would give taxpayers too much freedom to determine when they wanted to recognize gain.[154] While it is clear that someone must choose between these themes and decide whether or not taxpayers should be permitted to back into or out of section 332, it is doubtful that anyone has values or experiences from which to derive the optimal level of permissiveness.[155]

Would it be appropriate, then, for a judge who must resolve a recharacterization dispute about backing-in or other corporate tax issues that defy normative argumentation to turn to retrospectively descriptive theories for guidance? In the field of corporate tax law, this question should be answered affirmatively. In particular, cases concerning backing-in, distributions of boot,[156] and other matters that arise because of the arbitrary foundations of the tax system *should* be decided in ways that conform to the complete, consistent, brief, and direct qualities of other corporate tax decisions, unless these positive tools are

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[152] Over many years, with either retained earnings or inflation in the picture, there is likely to be more untaxed appreciation and, therefore, a greater disinclination to sell the asset and trigger a tax.

[153] Individual shareholders could not also be given the §§ 337-332 option because it would be too simple to move assets in (with a tax-free incorporation under § 351, which also requires an 80% transferor) and out of corporate solution depending on the tax rates applicable to individuals and to shareholders. *See* I.R.C. §§ 332, 337 (1982 & West Supp. 1987); I.R.C. § 351 (1982).

[154] If assets could be moved between corporations with even the smallest ownership ties, taxpayers in no need of funds for consumption purposes would essentially be able to trigger taxation only when they desired. Again, taxpayers would look for low-tax years.

[155] This elusiveness is just as easily seen in the context of the other subjects addressed in this Article. The excess salary question discussed in Section A of Part II, for instance, can be seen as a version of the arbitrary question of the scope of the two-tier tax bite. Similarly, bootstrap acquisitions, explored in Section B of Part II, combine the question of when to recognize gain, in the form of a second tax, with the question of how to divide a tax between two parties when each can be said to be better off. No general solution to this last question is possible, much as there is no general solution to the question of how two parties will bargain to divide a gain or to reach a price between two constraints.

[156] *See supra* notes 85-122 and accompanying text.

thought somehow to be normatively offensive or until competing, more successful retrospectively descriptive tools are developed, in which case these new tools ought to guide decisions.

There are two distinct reasons for the affirmative conclusion just given and, therefore, for the view that the positive tools developed earlier in this Article should play a role in the crafting of future decisions. The first reason is the rather dull and conservative notion that there is a need for judicial restraint. Judges should seek out and follow precedential patterns because, in this context, it is an effective way of making the law certain, stable, and predictable, a state that virtually all citizens affected by the corporate tax would favor. It is useful to fulfill expectations about the outcomes of decisions in order to aid parties in the planning of their affairs, and retrospectively descriptive patterns provide such an expectation in an almost unique way. More importantly, the constraints provided by retrospectively descriptive theories can curtail corruption and the errors of arrogance.[157] This assertion that the "errors of arrogance" will be diminished by additional precedents in the form of descriptive theories means nothing more than that many judges may in the aggregate be wiser, and even more likely to stumble on some normatively appealing rule, than only one judge. Ultimately, there is also the chance that judges who wish not to be bound by patterns not articulated by their predecessors will state their own reasons for given decisions and in this way offer other judges alternative means with which to decide cases.

The second reason to favor using retrospectively descriptive tools in deciding new cases is related to the underlying *in*separability of positive and normative concerns.[158] Positive and normative claims are inseparable in the familiar sense that neither can be torn free from the observer's experiences. If complete, consistent, brief, and direct recharacterizations have had relatively great success in past decisions despite the fact that these rules are never articulated and that there is no evolutionary explanation for their emergence, it must be for the same reason that many readers will find these four characteristics to be plausible positive tools;[159] shared experiences and a cultural framework

[157] Corruption is constrained because, when nothing seems to bind a decisionmaker, it is easier for her to be swayed by what is irrelevant or self-serving.

[158] In discussing the separability of positive and normative theories earlier, *see supra* note 144 and accompanying text, this Article focused on the question of whether a given positive theory compelled a normative view or vice versa, in some direct way, or whether the two are separable other than in the sense that nothing in human judgment can be entirely separated from cultural and other influences on that judgment.

[159] Positive theories are often most convincing when they identify some structural or evolutionary mechanism that causes decisions to be made in the suggested manner.

produce a common aesthetic sense, or taste, as to order and elegance. It is not surprising that scientists find simple geometric forms, "natural" logarithmic relationships, and short formulas to be elegant and attractive explanations of observed phenomena, while many students of corporate tax law, in similar fashion, find brief and direct recharacterizations appealing. The tools with which one describes the past and present are themselves the product of a shared sense of how to order the mysteries confronting every observer. While no one can claim that a community's tastes somehow rise to the level of objective truth or good, it is sensible to suggest that lawmakers ought to provide constituents with results that will be perceived as well-ordered.

CONCLUSION

In all of law there is a delicate and mysterious interaction between positive and normative approaches. Positive theories of law are normally most convincing when accompanied both by normative arguments that appeal to the inclinations of the audience to which these arguments are presented and by evolutionary or causal arguments explaining how the law came to take its shape. Such positive theories, however, are relatively rare. When a positive theory lacks these two escorts, its role in helping to decide cases is limited. This Article has attempted to develop four retrospectively descriptive, positive tools that are of interest standing alone but that also raise provocative questions about the interaction between positive and normative theories in an area of law in which such questions are, to say the least, not customarily discussed. To the extent that corporate tax law and, perhaps, some other areas of law are peculiarly immune to external, normative arguments, there is every reason to believe that descriptive arguments gain added importance as the means by which new cases ought to be decided.

Positive theories might thus be regarded as "explained" or "unexplained." It is hard to see what evolutionary mechanism caused complete, consistent, brief, and direct recharacterizations. Economies governed by decisions that were not always direct or brief could certainly survive in historical terms.

It should be emphasized that these four "hidden rules" are not necessarily the *most* plausible or elegant. Recharacterizations might have conformed to the equal treatment rule (they did not, although the rule seemed quite elegant), or might have demonstrated some sense of "symmetry," or might have been retrospectively described in a manner that blended with common aesthetic preferences. The point is both that detective work about past decisions may reveal the subset of such inoffensive and even attractive tools that appealed to previous decisionmakers and that it is these tools that ought to be used. The requirement of retrospective description will serve to constrain each generation of decisionmakers.